
FINAL NOTICE

To: JPMorgan Chase Bank, N.A.
FRN: 124491
Address: 25 Bank Street
Canary Wharf
London
E14 5JP
Date: 18 September 2013

1. ACTION

- 1.1. For the reasons given in this notice, the Authority hereby imposes on JPMorgan Chase Bank N.A. ("the Firm") a financial penalty of £137,610,000.
- 1.2. The Firm agreed to settle at an early stage of the Authority's investigation. The Firm therefore qualified for a 30% (stage 1) discount under the Authority's executive settlement procedures. Were it not for this discount, the Authority would have imposed a financial penalty of £196,586,000 on the Firm.

2. SUMMARY OF REASONS

- 2.1. On 13 July 2012 J.P. Morgan Chase & Co. ("the Group") announced that the Firm's Synthetic Credit Portfolio ("SCP"), a trading portfolio housed within the Firm's Chief Investment Office ("CIO") in London, had lost \$5.8 billion in the first six months of 2012. The Group also announced a restatement of its first quarter net income which included the Firm's results, lowering the figure by \$459 million. By the end of 2012, the trading losses in the SCP amounted to \$6.2 billion. These losses were the result of what became known as the "London Whale" trades.

- 2.2. The Firm's failings were extremely serious. The losses were caused by a high risk trading strategy, weak management of that trading and an inadequate response to important information which should have notified the Firm of the huge risks present in the SCP. Flaws in the Firm's marking and valuation control process for the SCP meant that the Firm failed to price certain positions within the SCP accurately in 2012. As losses began to mount during 2012, those flaws allowed traders on the SCP to conceal them through mismarking the SCP's positions. At month-end in February 2012, a substantial amount of trading was undertaken on the IG9 10 year index. One of the purposes of part of this trading was to "*limit the damage*" to the SCP. This could have been achieved if the market price of the index moved closer to the SCP's mark. In addition to these failings, between January and July 2012, the Firm failed to be open and co-operative with the Authority about the extent of the losses as well as other serious and significant issues regarding the risk situation in the SCP.
- 2.3. Following press speculation about the SCP's positions in April 2012, the Firm's understanding of the underlying issues developed over time, resulting in a number of public statements by the Group and Firm which provided additional information as it became known. These included the publication of the results of the Group's internal investigation into the SCP in January 2013, and comments made by the Group's Chairman and Chief Executive Officer.
- 2.4. The Authority considers that the matters set out above and described in more detail in section 4 below undermined trust and confidence in UK financial markets.

SCP trading strategy

- 2.5. The trading strategy for the SCP in 2012 was, in the words of Jamie Dimon (the Group's Chairman and Chief Executive Officer), "*flawed, complex, poorly reviewed, poorly executed and poorly monitored*". The strategy caused the size of the SCP's positions to grow so large that it was at risk of substantial losses from even a small adverse market move.
- 2.6. Risk limits were being breached from January 2012. However, the Firm responded inadequately to these indications of increasing risk. In particular, changes were made to a relevant risk evaluation model, without the necessary amendment to the corresponding risk limit. The effect was that, because the limit remained unchanged, the SCP was able to take on increasing risk, without breaching its limit.

- 2.7. In April 2012, the size of the SCP's positions became known to the rest of the market: traders working on the SCP were the subject of newspaper articles opining upon the size of the SCP's positions, and alleging that the SCP's trading had "*helped move the index*". The SCP suffered heavy losses following the publication of the articles, as the market moved against its large portfolio.

Mismarking the SCP's positions and market misconduct

- 2.8. From 2007, at the direction of SCP management, the traders on the SCP's approach to marking the SCP's positions was such that they provided an estimate of what they, the traders, thought the position was worth, rather than necessarily picking the mid of what the market thought the positions were worth. In February and March 2012 as the SCP began to lose substantial amounts of money, traders on the SCP began to mark their positions in a noticeably favourable manner. At the direction of SCP management, they priced the positions at the most beneficial end of the bid-ask spread. This had the effect of making the SCP appear more profitable and enabled the traders to conceal the scale of the losses arising in the SCP from CIO Senior Management.
- 2.9. The IG9 10 year index was the biggest contributor to the profit and loss in the SCP. As February 2012 month-end approached, traders on the SCP, with the knowledge of SCP management, engaged in substantial trading in that index, in particular on 29 February. One of the purposes of part of this trading was to "*limit the damage*" to the SCP. This could have been achieved if the market price of the index moved closer to the SCP's mark.
- 2.10. By March 2012, it was clear to the traders on the SCP that the adverse market moves were continuing against the SCP's positions. In order to conceal this from CIO Senior Management, traders on the SCP continued to mark aggressively. By mid-March, they had gone further and, at the direction of SCP management, deliberately mismarked the SCP in order to conceal what one trader believed to be genuine losses. On 16 March 2012, the traders calculated that the losses appeared to be understated by almost \$500 million, based on their estimation of market mid-prices. Nonetheless on that day the portfolio only showed a loss of \$4 million in its internal reporting to CIO Senior Management.
- 2.11. Shortly thereafter, CIO Senior Management began to engage with the trading problems arising in the SCP and its traders were ordered to stop trading. The SCP's true losses continued to be concealed from CIO Senior Management by

mismarking, although the reported losses within the SCP by that date were substantial and there had been further risk limit breaches.

- 2.12. Flaws within CIO's Valuation Control Group ("CIO VCG"), which had responsibility for valuing the SCP, meant that the Firm failed to detect the mismarking in the first quarter of 2012 in a timely manner. CIO VCG in Europe was under-resourced, its policies badly implemented and its procedures inadequate. These flaws enabled interference with the month-end valuation process conducted by CIO VCG, a process which was intended to act as a control over the way traders on the SCP marked the portfolio. In February 2012, traders on the SCP deliberately sought to narrow the distance between their estimation of the portfolio's worth and CIO VCG's assessment, by seeking to influence the independent prices used by CIO VCG.
- 2.13. Ultimately, in the restatement of results published on 13 July 2012, the Group determined that a material control weakness had existed in the Firm's relevant internal controls over financial reporting as at 31 March 2012:

"During the first quarter of 2012, the size and characteristics of the synthetic credit portfolio changed significantly. These changes had a negative impact on the effectiveness of CIO's internal controls over valuation of the synthetic credit portfolio".

- 2.14. CIO VCG failed to fulfil its function and as a result there was an absence of adequate valuation control for the SCP in 2012. The Firm failed to price certain positions in the SCP accurately and failed to prevent or detect mismarking in the first quarter of 2012 in a timely manner. This failing contributed to the Group's inaccurate statement of its first quarter 2012 results.

Review of the SCP's valuations

- 2.15. In late April 2012, increasing losses and collateral disputes with trading counterparties caused the Firm to consider the SCP's valuations. Firm Senior Management began a review of the problems arising in the SCP. In explaining the extent of the Firm's response and its results, during an analysts call on 10 May 2012, the Firm summarised as follows:

"What have we done? We've had teams from audit, legal, risk and various control functions, all from Corporate, involved in extensive review of what happened. We have more work to do but it's obvious at this point that there are many errors, sloppiness and bad judgement".

- 2.16. As part of the work described above, Firm Senior Management commissioned a valuation validation review, which included setting up a number of different work streams to gather and analyse information about the valuations and valuation processes of the SCP. The Firm wished to ascertain whether the valuation of the SCP was in accordance with the relevant accounting standard, in part due to an imminent filing of the Group's first quarter net income (which included the Firm's results) with the U.S. Securities and Exchange Commission on 10 May 2012 ("the Regulatory Filing").
- 2.17. However, the valuation validation review which was undertaken failed to uncover the extent of the valuation problems present in the SCP. Work undertaken by the Firm's Corporate Controller's office did not adequately analyse all of the relevant issues and relied partly on information obtained from SCP management, traders on the SCP and CIO VCG personnel, the people whose valuations the Firm was assessing.
- 2.18. Firm Senior Management relied on the work undertaken by the Firm's Corporate Controller to support the Regulatory Filing. Firm Senior Management gave insufficient weight to inconsistencies raised in the information in its possession, especially in light of the context provided by the scale of the losses in the SCP. Other relevant information was not escalated to Firm Senior Management. More effective analysis of the information the Firm had gathered as part of the valuation validation review would have allowed the Firm to question better the valuation of the SCP by CIO and to query further its reliability for the purposes of the Regulatory Filing.
- 2.19. Firm Senior Management did not involve key parts of the Firm's overall control framework in the review. It did not inform Compliance in London that any sort of valuation review was being undertaken prior to 10 May 2012. In fact, Compliance was already in possession of key evidence which was highly relevant to the valuation review and which ultimately contributed to the Firm's conclusion that the SCP had been mismarked. The Firm also failed to inform the Group's Audit Committee of the details of the valuation validation review.
- 2.20. On 13 July 2012, the Group restated the Regulatory Filing made on 10 May 2012. The Group had by then concluded it was not satisfied that the March 2012 month-end marks reflected good faith estimates of the fair value of instruments in the SCP. More effective analysis of the information available as at 10 May 2012 may have prevented the need for this restatement.

Failure to be open and co-operative

- 2.21. In the first half of 2012 the Firm failed to be open and co-operative with the Authority about the extent of the losses as well as other serious and significant issues regarding the risk situation in the SCP, and on one occasion (by virtue of the conduct of CIO London Management) deliberately misled the Authority.
- 2.22. Despite the Authority informing the firm in May 2012 that its *"appetite for further surprises was close to zero"*, as the valuation issues on the SCP evolved in May and June 2012, the Firm did not inform the Authority of the work it had undertaken as part of the valuation validation review prior to 10 May 2012. Nor did the Firm inform the Authority promptly that it had become aware of some evidence indicating potentially serious misconduct by individuals approved by the Authority.

Conclusion

- 2.23. One of the Authority's operational objectives is protecting and enhancing the integrity of the UK financial system which includes seeking to ensure the orderly operation of the financial markets. The Firm's failings threatened this objective.
- 2.24. The Firm's conduct demonstrated flaws permeating all levels of the Firm: from portfolio level right up to Firm Senior Management, resulting in breaches of Principles 2, 3, 5 and 11 of the Principles for Businesses, which set out the fundamental obligations of all firms under the UK regulatory system. Whilst most of the Firm's failings occurred in the period between January and July 2012, certain flaws in its valuation processes were present from the start of 2007.
- 2.25. The Authority therefore proposes to impose a financial penalty on the Firm in the amount of £137,610,000 pursuant to section 206 of the Financial Services and Markets Act 2000 ("the Act").

3. DEFINITIONS

- 3.1. The definitions below are used in this Warning Notice.

"the Act" means the Financial Services and Markets Act 2000

"the Authority" means the body corporate previously known as the Financial Services Authority and renamed on 1 April 2013 as the Financial Conduct Authority

"CDS" means Credit Default Swap

"CIO" means the Chief Investment Office of JPMorgan Chase Bank, N.A.

"CIO VCG" means the valuation control group within the Chief Investment Office responsible for valuing the SCP in EMEA

"CRM" means Comprehensive Risk Measure

"CSW01" means Credit Spread Widening by one basis point

"CSW10%" means Credit Spread Widening by 10%

"Dear CEO letter" means a letter from the Chief Executive of the Authority to the Chief Executive Officer of the Firm dated 13 August 2008 relating to valuation and product control

"DEPP" means the Authority's Decision Procedure and Penalties Manual

"the Firm" means JPMorgan Chase Bank, N.A.

"the Group" means J.P. Morgan Chase & Co.

"IB VCG" means the valuation control group within the Group's Investment Bank

"IG9" means the CDX.NA.IG.9 index

"IG9 10 year index" means the CDX.NA.IG 9 10 year index, created in 2007 and with a maturity of 10 years

"Principles" means the Principles for Businesses

"the Regulatory Filing" means the filing of the Group's first quarter net income with the U.S. Securities and Exchange Commission on 10 May 2012. This included the Firm's results, broken down by line of business. CIO's results were reported as part of the Corporate/Private Equity line of business.

"RWA" means Risk Weighted Assets

"SCP" means the Synthetic Credit Portfolio

"the Tribunal" means the Upper Tribunal (Tax and Chancery Chamber)

"US GAAP" means United States Generally Accepted Accounting Principles

"VaR" means Value at Risk

4. FACTS AND MATTERS

Introduction

4.1. This section sets out the facts and matters regarding:

- (a) Relevant background (see paragraphs 4.2 to 4.9);
- (b) Failures relating to the trading strategy for the SCP (see paragraphs 4.10 to 4.29);

- (c) Paying insufficient attention to risk systems and controls (see paragraphs 4.30 to 4.54);
- (d) Mismarking of the SCP (see paragraphs 4.55 to 4.70);
- (e) Market misconduct (see paragraphs 4.71 to 4.77);
- (f) Critical valuation control flaws (see paragraphs 4.78 to 4.98);
- (g) Opportunities to question valuation (see paragraph 4.99 to 4.103);
- (h) Firm Senior Management's response (see paragraphs 4.104 to 4.126);
- (i) Failure to involve key control functions (see paragraphs 4.127 to 4.132);
- (j) Events leading up to restatement (see paragraphs 4.133 to 4.134); and
- (k) The Firm's failure to be open and cooperative with the Authority (see paragraphs 4.135 to 4.147).

Relevant background

- 4.2. This section (paragraphs 4.2 to 4.9) provides background information regarding the SCP, in particular its location within CIO and the Firm, and the credit derivative instruments traded within the SCP.
- 4.3. The Firm is a wholly owned subsidiary of the Group. CIO operates within the Firm in both New York and London. The traders on the SCP were managed by SCP management, which in turn were managed by CIO London management. CIO London management represented the most senior level of management for the SCP in London, reporting directly to CIO Senior Management in New York, which in turn reported to Firm Senior Management. CIO also had its own Risk, Finance and VCG functions, which were control functions relevant to the SCP and other portfolios within CIO. The wider control functions within the Group included Internal Audit, Compliance and the Group's Audit Committee.
- 4.4. CIO was responsible for managing the Firm's excess deposits, and the majority of portfolios within CIO benefited when credit markets performed well. The scale of the business was vast. From 1 January 2007 to 31 December 2011, CIO grew in revenue size from \$803 million to \$3.3 billion, peaking at \$8.3 billion in 2009.

- 4.5. The trading in the SCP related to the trading of credit instruments, most particularly credit default swap indices. A credit default swap (CDS) is a type of credit derivative. Typically credit derivatives derive their value from the creditworthiness of an issuer of a debt instrument. CDSs allow investors to express a view on the creditworthiness of a company by buying or selling protection.
- 4.6. An investor who buys a CDS buys protection from another market participant (the protection seller) regarding a credit event, such as bankruptcy or failure to pay, occurring in relation to a particular company's debt. In circumstances where a credit event does occur, the investor will receive compensation from the seller of protection. The price or value of a CDS will fluctuate over time depending on investor sentiment towards both the credit market in general and the creditworthiness of the relevant company in particular.
- 4.7. A CDS index is a collection of selected CDSs. An index allows an investor to buy or sell protection in relation to a credit event affecting the companies whose CDSs comprise the index. CDS indices exist for different portions of the CDS market. In particular, they may reference different levels of creditworthiness. For example, there are investment grade and high yield CDS indices. An investment grade CDS index references the CDSs of certain companies whose debt is categorised as investment grade and a high yield CDS index references the CDSs of certain companies whose debt is categorised as high yield. The probability of a credit event occurring on debt that is categorised as investment grade is lower than that of debt which is categorised as high yield.
- 4.8. Some CDS indices are also available in a segmented format, referred to as tranches. Tranches may also be traded by investors and allow them to buy or sell protection on a specified portion of the index.
- 4.9. One of the indices the SCP traded significantly in 2012 was the CDX.NA.IG9 10 year index ("the IG9 10 year index"). When this index was created in 2007, it was made up of 125 CDSs referencing the debt of investment grade companies in North America. Buyers and sellers of this index buy and sell protection in relation to the companies whose CDSs comprise the index and that protection lasts until December 2017, 10 years after the index was initially created. Investors can trade in the IG9 10 year index to hedge their other exposures and/or to speculate on whether the value of the index will rise or fall. If an investor considers that market conditions are going to deteriorate and the potential for a credit event will

increase and therefore the value of the index will rise, he will buy protection (also known as selling risk). If on the other hand he considers that market conditions will improve and the value of the index will fall, he will sell protection (also known as buying risk).

The trading strategy

- 4.10. This section (paragraphs 4.10 to 4.29) sets out the establishment of the SCP in 2006, its evolving strategy, and the performance of the SCP in 2012. In particular, this section describes the different motives for the 2012 trading strategy, which each resulted in the addition of positions to the SCP and caused a dramatic increase in its notional size. Market conditions in 2012 contributed to escalating losses in the SCP, and this problem was exacerbated by the increase in its size. The escalating losses led ultimately to the replacement of the SCP management team in late April 2012.
- 4.11. In May 2006, CIO approved a new business initiative to allow it to establish a portfolio which traded credit instruments. The economic rationale for this new initiative was to counter CIO's "*cyclical exposure to credit*", which was identified as "*the single largest risk concentration from the operating businesses*" within CIO. The SCP was created as a result of this initiative and was run by CIO in London. From 2007, the SCP mostly utilised CDS indices and related tranches, trading a variety of these instruments and both buying and selling protection. These products were marked to market each day, and the prices were subject to review by CIO VCG at month-end. There were several flaws in the Firm's valuation processes (see paragraphs 4.78 to 4.98).
- 4.12. In 2009, the SCP generated a significant amount of revenue for the Firm. In the first two quarters of 2009, the SCP had initially lost a substantial amount (approximately \$400 million). However, traders on the SCP had maintained the SCP's strategy, despite the market moving against them, and ultimately the SCP returned to profitability, generating a healthy revenue for the Firm. The SCP was also a particularly profitable book for the Firm in 2011. As a result of American Airlines filing for bankruptcy alone, the SCP earned \$400 million. By December 2011, the SCP had a notional size of \$51 billion and had generated approximately \$2 billion in gross revenue for the Firm.
- 4.13. The strategy devised for the SCP in 2012 required a reduction in the SCP's use of Risk Weighted Assets ("RWA"), in part owing to the Firm's preparation for regulatory changes to its capital requirements. In simple terms RWA assesses the

relative risk of a firm's assets. The calculation weights each asset according to the asset's risk, in order to determine a firm's exposure to potential losses. The RWA calculation, amongst other things, determines the minimum amount of capital a firm is required to hold under relevant capital adequacy rules. The riskier a firm's assets, the more capital the firm will be required to hold to offset the potential loss.

- 4.14. The RWA reduction proposed initially for CIO in 2012 was \$20 billion. However, at the end of December 2011, CIO Senior Management requested information about an additional \$15 billion reduction in CIO's use of RWA in the first quarter of 2012. One way of achieving such a reduction would have been to reduce the notional size of the SCP by unwinding positions. CIO Senior Management were informed that a reduction in RWA of \$10 billion by the end of 2012 would require 35% of the SCP to be unwound. This would come at an estimated trading cost of \$516 million and would also reduce by an estimated \$133 million, the amount that the SCP was forecast to receive by selling protection.
- 4.15. However, traders on the SCP noted that \$5 billion of the reduction could be achieved by changing the methodology used to calculate RWA (a project SCP management had been working on since 2011). In particular they identified that a \$1 billion reduction in RWA would result from the proposed remodelling of the way Value at Risk ("VaR") was calculated for the SCP.
- 4.16. By early January 2012 the SCP had incurred mark to market losses of approximately \$15 million. CIO Senior Management were informed that unwinding the positions in the SCP *"opportunistically"* had been *"somewhat costly"*. CIO Senior Management decided to *"review the [RWA] unwind plan to maximise [profit and loss]"*, stating that *"we may have a tad more room on RWA"*. The *"room"* in the RWA reduction arose from a decision by the Firm's Senior Management not to seek any additional RWA reduction.
- 4.17. On 18 January 2012, SCP management again discussed with CIO Senior Management the fact that the SCP could achieve a substantial RWA reduction by using a different methodology for its calculation, which would reduce the SCP's use of RWA by around \$20 billion. SCP management recommended that this new model should be adopted and that they should embark upon an *"opportunistic risk reduction"* strategy, with the anticipated cost of the reduction being \$100 million.

- 4.18. On 19 January 2012, the SCP suffered a loss of \$50 million as a result of Eastman Kodak filing for bankruptcy. CIO Senior Management were told by the traders on the SCP that the SCP was not well positioned for this credit default event, because the traders believed that certain of the protection the SCP had against this default had expired in December 2011 and had not been renewed.
- 4.19. CIO Senior Management became concerned that, because of the loss suffered by the SCP due to the Eastman Kodak default, the SCP may not have adequate protection should other credit defaults occur in the indices and tranches traded by the SCP. As a result, CIO Senior Management instructed traders on the SCP to ensure that the SCP had appropriate *"jump to default"* protection, to ensure losses were not suffered through further credit defaults. *"Jump to default"* exposure is the risk of sudden defaults on debt, for example by companies going bankrupt unexpectedly, causing immediate losses to an investor who has sold protection on the relevant debt. In order to comply with this instruction traders on the SCP began to buy large quantities of protection on the high yield indices. The addition of this *"jump to default"* protection required CIO to pay premiums to the counterparties from whom it bought the protection, thereby incurring a trading cost for the SCP.
- 4.20. Market conditions caused the SCP to continue to lose money during January 2012. By 26 January 2012, traders on the SCP believed the year to date losses to be around \$100 million and anticipated a further \$300 million in losses might be forthcoming. SCP management proposed a strategy to CIO Senior Management which they believed would allow them to reduce the SCP's use of RWA, provide jump to default protection and stem the losses occurring in the SCP. The proposal involved:
- (a) adding positions which would better balance the SCP from a risk perspective, with a view to reducing its use of RWA;
 - (b) ensuring the portfolio was better protected from defaults in the credit market by buying protection on high yield indices; and
 - (c) maximising profit by adding positions to the portfolio which would fund the cost of (a) and (b) above.
- 4.21. The strategy was intended to address some of CIO Senior Management's priorities for the SCP but in each case the strategy involved the addition of positions to the SCP. It involved selling protection on investment grade indices, in particular on

the CDX.NA.IG.9 credit index ("IG9"). Selling the protection earned premiums, which helped offset the cost of buying protection on the high yield indices, and traders on the SCP believed that this would also assist in balancing the SCP within an RWA reduction plan.

- 4.22. The strategy was duly implemented with no objection from CIO Senior Management. By the end of January 2012, traders on the SCP had increased its notional positions in the IG9 10 year index by \$20 billion, despite noting concern about the increasing size to SCP management:

"[T]he control of the drawdown now is generating issues that make the book only bigger in notionals...[T]he notionals become scary and [the] upside is limited unless we have really unexpected scenarios. In the meantime we face larger and larger drawdown pressure versus the risk due to notional increase".

- 4.23. Nonetheless, the strategy was pursued during February and March 2012, despite ever increasing losses. By the end of February, the SCP had reported \$180 million of year to date losses, more than half the estimated maximum loss that traders on the SCP had forecast in January 2012 for the entire year. By the end of March the reported losses had increased to \$568 million, although the actual figure may have been hundreds of millions of dollars higher (see paragraphs 4.63 to 4.65 below). At the same time, the notional size of the SCP had increased to \$157 billion by 30 March 2012.

- 4.24. By 23 March 2012, CIO Senior Management became concerned by the continued addition of positions and increasing RWA numbers. CIO Risk emailed SCP management and CIO London management stating that CIO Senior Management were "freaking" because it had been unaware "*from the two hour meeting [between SCP management, CIO London management, CIO Risk and CIO Senior Management]...that the current capital numbers did not include position changes from [7 March 2012]*". The position changes made to the portfolio were estimated by CIO Risk to add a further \$6-8 billion to the SCP's use of RWA. The email set out that CIO Senior Management did "*not understand why this was not mentioned by any of us in the two hour meeting...and why we have kept changing positions this week...I haven't seen [them] this upset since I've been here*".

- 4.25. Thereafter CIO Senior Management ordered the traders on the SCP to stop trading, due to a loss of faith in the traders' abilities to achieve the SCP's objectives. On 30 March 2012, CIO London management sent an email entitled

"synthetic credit – crisis action plan". CIO London management noted that "as we already had several meetings on this, we must get it right this time, otherwise we could lose our collective credibility... Due to the size of the book, we only have 'one move' to achieve our dual objective of stabilizing the risk and P+L of the [SCP] while achieving our targeted RWA objectives...[t]herefore the objective is to determine what is the best course of action to ensure that the book is and remains balanced in risk and P+L terms...clearly, we are in crisis mode on this. The crisis team is to have short daily meetings". CIO London management also noted in an email sent later that day that the IG9 investments made by the SCP had resulted in "almost total loss of hedging effectiveness".

- 4.26. The SCP's very large position in parts of the credit derivatives market made it more vulnerable to market moves and served to make its positions obvious to other market participants. On 6 April 2012 an article published in the Wall Street Journal ("*London Whale' Rattles Debt Market*") drew attention to the size of the SCP's position in the IG9. The market reacted to the speculation about the SCP's positions and on 10 April 2013, the first trading day after the article appeared, the SCP recorded mark to market losses of \$412 million, although traders on the SCP had estimated earlier in the day that the losses that day could be in the region of \$700 million.
- 4.27. Following the publication of the article Firm Senior Management asked for several analyses of the SCP in order to better understand how the SCP was balanced and its likely second quarter results. These analyses also informed Firm Senior Management about the notional size of the SCP's positions. One of the analyses provided to Firm Senior Management showed an 80% likelihood of a second quarter profit and loss result in the range of negative \$250 million to positive \$350 million with a 10% extreme result of negative \$650 million and a 10% optimistic result of positive \$1.725 billion.
- 4.28. This information was considered by Firm Senior Management prior to an earnings call on 13 April 2012. As a result of the information received, Firm Senior Management sent an email to another manager describing the media attention to be *"a tempest in [a] teapot driven by sour grape hedge funds and some former baby employees"*. However, by the end of April the losses on the SCP had increased dramatically, with a loss of almost \$800 million between 23 and 30 April 2012 alone. As a result of this and a number of collateral disputes, towards the end of April, Firm Senior Management commissioned an independent position by position review of the SCP. On learning of the early findings, Firm Senior

Management immediately installed a new management team to run the SCP on an interim basis.

- 4.29. The Firm's breach of Principle 2 as it relates to the management of the trading strategy on the SCP is set out at section 5 below (Failings).

Risk systems and controls

- 4.30. This section (paragraphs 4.30 to 4.54), describes the risk measures and limits in place for the SCP, the repeated breaches of those limits and the Firm's response to those breaches.
- 4.31. One of the purposes of measuring the risk in a trading portfolio and setting risk limits is to alert management to the existence of and increase in any potential risks present in a portfolio. Management can then determine the cause of the increased risk, assess the potential consequences and devise a strategy to deal with the issue.

Value at Risk

- 4.32. One relevant measure of risk is VaR, a statistical measure used to estimate profit and loss movement ranges on a portfolio of assets. It represents an estimate of the maximum mark to market loss over a fixed time period, assuming historical market conditions and stated to a degree of confidence. VaR was measured at Firm-wide level and at CIO level, with risk limits in place at both levels.
- 4.33. By January 2012 VaR limit breaches were already indicating that there was increased risk present in the SCP. On 10 January 2012 both Firm Senior Management and CIO Senior Management were notified by routine risk reporting that as at 9 January 2012 the Firm was utilising 98% of its \$125 million 95% 10Q VaR limit, and that CIO was using \$88 million of CIO's \$95 million stand-alone VaR limit. When CIO Senior Management requested a breakdown of the CIO VaR figures, they were informed that the increase had arisen because of trades placed in the SCP between 19 December 2011 and 6 January 2012. On 10 January CIO Risk also notified traders on the SCP and SCP management that the SCP's VaR had increased by approximately 25% between 21 December 2011 and 9 January 2012 due to its increased positions, and that the SCP alone was now using \$93 million of CIO's \$95 million VaR limit.
- 4.34. In mid-2011, CIO Senior Management had decided that the VaR model used by the SCP needed to be updated because the methodology by which VaR was calculated for the SCP was overly cautious, leading to figures which were not

indicative of the actual risk present in the portfolio. As a result they had given approval to the development of a new VaR model. In January 2012 CIO Senior Management was notified that the introduction of the new model would result in “*CIO VaR reduction in the SCP by 44%*”. That model was close to being approved by mid-January.

- 4.35. By 16 January 2012, CIO had exceeded its own VaR limit and was also a contributory factor in a breach of the Firm-wide VaR limit. The breaches continued for three days thereafter. CIO Senior Management understood that the VaR increase was driven by additional positions within the SCP, and that VaR would be reduced through position offsets and the new VaR model. CIO Senior Management did not request an immediate reduction of the positions within the SCP. CIO Senior Management continued with the VaR model change, understanding that it would reduce the VaR calculation for the SCP.
- 4.36. On 23 January 2012, a temporary increase of \$15 million in the Firm-wide VaR limit was proposed, on the basis that steps were being taken to reduce VaR by offsetting positions and through the implementation of the new model. Senior Risk Personnel did not ask for any further explanation and accepted the proposal. Firm Senior Management then approved the temporary increase. The Authority has seen no evidence to suggest that there was any consideration given to the speed at which VaR had been increasing within the SCP in January 2012 by either Firm Senior Management or CIO Senior Management despite the fact that VaR limit breaches had not been a feature of the SCP during 2011.
- 4.37. By 25 January 2012 CIO’s 10Q VaR totalled \$111 million, breaching CIO’s temporarily increased VaR limit of \$110 million. CIO’s increase had again contributed to a breach of the Firm’s temporarily increased VaR limit of \$140 million. CIO Senior Management were informed that from 30 January “*the new methodology should become the official firm submission...[l]imit issues should therefore cease beginning from Monday*”.
- 4.38. In retrospect, the new VaR model was not fit for purpose. Relevant expertise within the Firm was not utilised adequately during the model’s development and the calculation was overly reliant on manual processes and contained significant errors. One such calculation error caused the overall output of the new model to be halved, resulting in a significantly inaccurate final figure (although the Firm is unable to confirm with what frequency the error in question occurred).

- 4.39. As the VaR limit breaches began to occur in January, SCP management sought to “keep the pressure on our friends in Model Validation and [Quantitative Research]” in order to ensure the new model was approved as swiftly as possible. There was inadequate back testing of the model. The Authority agrees with the Firm’s assessment, made in the task force report (the Group’s internal investigation into the SCP published in January 2013), that the Model Review Group may have:

“accelerated its review as a result of this pressure, and in so doing it may have been more willing to overlook the operational flaws apparent during the approval process”.

- 4.40. The new model reduced the calculation of CIO 10Q VaR within the SCP to \$66 million, a reduction of more than 40% on the previous day’s VaR. This reduction did not result in a corresponding decrease in CIO’s VaR limit. Although CIO Senior Management were considering a limit reduction during February and March 2012, no such decrease was effected by the incumbent CIO Senior Management. Therefore the effect of the change in methodology was that, because the limit remained unchanged, the SCP could take on greater risk without being in breach of its limit.

The Comprehensive Risk Measure

- 4.41. VaR limit breaches were not the only indicators of the increasing risk in the SCP. Another measure of risk used in calculating the Firm’s capital requirements, the Comprehensive Risk Measure (“CRM”), showed risk in the SCP increasing during early 2012. In calculating CRM, historical figures are used to estimate a figure for the potential losses in a portfolio over the course of one year in high levels of market stress. The CRM figure formed part of the Firm’s RWA calculation.
- 4.42. On 18 January 2012, CIO’s CRM results totalled \$3.154 billion. Due to a technical difficulty experienced by the Firm’s Quantitative Research team, CRM figures were not calculated for the next five weeks. On 2 March 2012, CIO Risk received newly calculated CRM figures for CIO setting out the figures from 22 February 2012. These figures showed that CRM had doubled since the previous calculation and was now at \$6.3 billion.
- 4.43. CIO Risk challenged the accuracy of the numbers:

"These results, if I understand them, suggest that there are scenarios where the [SCP] could lose \$6B in one year. That would be very difficult for us to imagine given our own analysis of the portfolio".

- 4.44. Forwarding the results on to SCP management and traders on the SCP, CIO Risk noted:

"We got some CRM numbers and they look like garbage as far as I can tell, 2-3x what we saw before. They came from the technology guy running the process, so probably [Quantitative Research] has not even reviewed the results".

- 4.45. CIO Risk contacted the Firm's model risk and development group to query the results. CIO Senior Management and CIO Risk subsequently received a clear response from the model risk and development group's investigation as follows:

"Based on our models, though, we believe that the \$3bn increase in RWA is entirely explained by a \$33bn notional increase in short protection (long risk) in [the SCP] between Jan and Feb...I understand that we have to build your confidence in our models themselves but, given our models, we believe the increase in RWA is well explained by the build up in your risk positions".

- 4.46. CIO Senior Management noted that this response was "not consistent" with CIO London management's explanation of the RWA position and SCP management were asked for further information. However, the Authority has not seen any evidence to suggest a reduction in the notional size of the SCP was considered as a result of the CRM results.

- 4.47. The CRM figures were part of a broader picture that could have led to an earlier appreciation of the risks being run by traders on the SCP. Although the CRM figures were investigated, the Firm's ultimate response demonstrates the inadequacy of the monitoring of that risk within CIO.

Credit spread risk limits

- 4.48. Breaches of credit spread risk limits were also warning about the increasing risk in the SCP. Two relevant limits utilised in CIO were CS01 and CSW10%. Both of these measurements relate to the effect of movements in credit spreads. CS01 is used to measure the sensitivity of a portfolio to a one basis point movement in credit spreads, providing an estimate of the profit and loss effect. CSW10%

measures a portfolio's sensitivity to a widening in the credit spread of 10% and again calculates an estimate of the resulting profit and loss effect.

4.49. On 6 January 2012, the SCP breached the \$5 million mark to market CS01 limit. The breach continued for four months, until the limit was replaced in May 2012. By 7 February 2012, the breach was in excess of triple the current limit. A senior manager in CIO learned of the limit breach on 13 February 2012 and responded that they *"had no memory of this limit. In any case it needs to be recast with other limits. It's old and outdated"*. This reflected a view within CIO that the CS01 measurement was not a sufficiently useful one, considering the composition of the SCP. The Firm's Investment Bank performed a more useful analysis of CS01 data, however no steps were taken to utilise this alternative approach within CIO. By 30 March 2012, CIO's CS01 breach was more than 900% of the limit.

4.50. In addition to the persistent and substantial CS01 breaches, the CSW10% limit was also breached on 22 March 2012, with the breach remaining until 1 May 2012. This limit breach should have alerted CIO Senior Management to the dangerous level of risk they had allowed the SCP to run for the last three months.

The Firm's response

4.51. Firm Senior Management has indicated that risk limits are generally set at a low level deliberately, in order to trigger breaches of the limit and therefore encourage debate about the cause of the limit breach. However the Authority has found no evidence to indicate any such debate or analysis was routine for the SCP. In fact, instead of operating as warning signs of a potential and growing problem, CIO Senior Management's approach to risk measurements allowed the traders on the SCP to take increasingly risky positions.

4.52. The Firm itself has concluded, in its own review into CIO's losses published in January 2013 that it:

"did not ensure that the controls and oversight of CIO evolved commensurately with the increased complexity and risks of CIO's activities... As a result, significant risk management weaknesses developed within CIO that allowed the traders to pursue their flawed and risky trading strategies...firm Senior Management...did not do enough to verify that CIO was well managed or that the firm was fully applying its various risk and other controls to the [SCP's] activities".

4.53. The Authority considers that CIO Senior Management and CIO Risk's responses to limit breaches within CIO in 2012 were:

- (a) to assume the numbers provided which indicated a breach were unreliable (as regards the VaR and CRM figures);
- (b) to doubt the accuracy of the methodology for measurement of risk (as regards the VaR, CRM and CS01 methodologies); and
- (c) to approve temporary increases to limits without adequate analysis of the root cause of the breaches (as regards the VaR and CS01 limits).

4.54. As a result, CIO Senior Management allowed the SCP to significantly increase its risk profile between January and March 2012, in circumstances where a badly managed trading strategy was already causing escalating losses. The Firm's resulting breaches of Principles 2 and 3 are set out at section 5 below (Failings).

Mismarking of the SCP

4.55. This section (paragraphs 4.55 to 4.70) sets out facts relevant to the method by which the positions on the SCP were marked on a daily basis. In the first quarter of 2012 the marks became more aggressive, in February 2012 traders on the SCP subverted the month-end valuation control process, and by March 2012 traders on the SCP and SCP management concealed losses from CIO Senior Management by mismarking the SCP.

4.56. The Firm's books and records are maintained in the United States. Therefore the Firm valued the positions in the SCP in order to meet the requirements of the United States Generally Accepted Accounting Principles ("US GAAP"). The relevant provision of US GAAP required the assets held in the SCP to be valued at fair value. This is defined in the relevant accounting standard as the price at which the valuer estimates the asset could be traded on the day of the valuation, assuming an orderly transaction. The accounting standard makes clear that if an asset has a bid price (a buy price) and an ask price (a sell price), the price within the bid-ask spread that is most representative of fair value in the circumstances should be used. US GAAP does not require mid-market pricing, but notes it may be used "*as a practical expedient for fair value measurements within a bid-ask spread*".

- 4.57. The SCP was required to be marked to market on a daily basis. This process was undertaken each day by traders on the SCP in order to provide a profit and loss estimate to CIO Senior Management, CIO London management and SCP management. The marks were inputted into the Firm's internal systems in order to produce reports for this purpose. At the end of every month the marks were tested by CIO VCG, in order to verify the valuations ascribed to the positions and enter those valuations into the Firm's books and records.
- 4.58. Traders on the SCP were permitted to mark a complex derivatives portfolio worth billions of dollars. The Firm's expectations were that the traders on the SCP would seek to comply with the requirements of US GAAP and the Firm considered the traders on the SCP to have sufficient trading and marking experience. However, the traders were unfamiliar with the relevant US GAAP provisions and the marking standards it imposed. The Firm never provided the traders on the SCP with any formal training, guidance or documented policy as to how the SCP should be marked. They were not directed to use relevant independent data sources.
- 4.59. SCP management directed traders on the SCP to mark their positions such that they did not necessarily pick the mid of what the market thought the positions were worth (which was described by SCP management as "*pressing F9 like a monkey*") but instead provided an estimate of what they, the traders, thought the positions were worth.
- 4.60. In February 2012, the aggregate difference between mid-market prices and the SCP's marks began to increase significantly. Traders on the SCP began to mark their positions more aggressively (moving away from the mid towards the more favourable end of the bid-ask spread). CIO VCG recognised the differences but did not notice this as a trend and therefore did not challenge the traders effectively.
- 4.61. Traders on the SCP provided additional broker runs to CIO VCG which persuaded CIO VCG to reduce the difference between the SCP's marks and CIO VCG's own independent marks from at least \$31 million to \$11 million on 1 March 2012. The traders considered they were producing "*better*" broker quotes for CIO VCG to "*justify*" the marks. Although traders on the SCP saw CIO VCG as a control function, one trader considered that accepting CIO VCG's proposed adjustments to the marks was not "*the way things worked at CIO*". The CIO VCG process was flawed and in addition was easily subverted at February 2012 month-end.

- 4.62. In March 2012, as the losses on the SCP mounted, SCP management gave a further direction as to how the SCP should be marked, telling traders on the SCP to ignore the losses arising on the portfolio through the underperformance of the trading strategy and only record those which could be explained by a particular market event. In essence, this amounted to an instruction to mismark the portfolio in order to conceal mark to market losses from CIO Senior Management.
- 4.63. Between 12 and 19 March 2012, traders on the SCP kept a spreadsheet recording the difference between the estimated mid-market prices and the marks that had been applied to the SCP, broken down into certain positions. One of the purposes of this spreadsheet was to inform SCP management of the size of the difference. On 12 March 2012, this spreadsheet showed that the difference amounted to \$203 million. By 16 March 2012, the difference had risen to \$498 million, and one trader had formed the view that this amount was now an actual loss that should be reported. Nonetheless the profit and loss estimate produced by traders on the SCP that day showed a loss of only \$4 million.
- 4.64. On 20 March 2012, the difference between the mid-market prices and the marks being applied to the SCP was so large, that the bid-ask spreads began to give traders on the SCP a "*headache*". In order to keep within the bid-ask spread, the traders on the SCP showed a loss of \$40 million. Had the full difference been reported on 20 March 2012, according to the spreadsheet maintained by the traders on the SCP, the year to date loss for the SCP would have been over \$500 million.
- 4.65. On the last trading day of March 2012, traders on the SCP were aware that, as usual, the marks they ascribed to the SCP that day would be reviewed by CIO VCG. Given the increased scrutiny over the SCP following CIO Senior Management's instruction to stop trading, the profit or loss figure for the day was also of particular interest to CIO Senior Management. SCP management instructed one of the traders to remain in the office, after the close of the London markets, in order to review the prices in the New York market in the hope of getting "*any better numbers*". The marks to be applied were the subject of repeated discussions involving SCP management, who requested that the loss shown on the SCP should be as low as possible. The losses reported to CIO Senior Management at March 2012 month-end were \$138 million for the day and \$583 million for the year. This did not however include the hundreds of millions of dollars of losses concealed from CIO Senior Management by traders on the SCP, at the instruction of SCP management.

- 4.66. During April 2012 the instruction by SCP management to conceal unexplained losses from CIO Senior Management developed into a reverse engineering of the profit and loss figures. Traders on the SCP were given a headline profit and loss number by SCP management and together with SCP management would move the prices to match.
- 4.67. On Friday 6 April 2012, the article published in the Wall Street Journal highlighted the size of the Firm's positions in the IG9 10 year index, creating further sensitivity to market moves. Activity in the US markets on Monday 9 April 2012 indicated that the SCP might suffer a massive loss as a result. The SCP was not marked again until Tuesday 10 April (owing to the Easter Monday Bank Holiday in the UK) at which point traders on the SCP could no longer conceal the losses in full.
- 4.68. In the early afternoon of Tuesday 10 April 2012 it appeared to traders on the SCP that the losses that day alone might amount to \$600-700 million. An estimated range of \$400-600 million was communicated to CIO London management as the result for the day. Instead, a loss of \$5 million was initially reported. A senior risk officer, who was unaware of that report, was informed by SCP management that the reason for the estimated range was dislocation in the market. The senior risk officer then told SCP management to reflect the market price and the losses arising therefrom. Subsequently, SCP management directed the traders on the SCP to show a \$400 million loss for the day. However, this figure still did not include the losses concealed by traders on the SCP since mid-March and was more favourable than the expectation provided to CIO London management earlier that day. The explanation given for the difference was that market prices had improved during the day.
- 4.69. When the new management team took over responsibility for the SCP in late April 2012, the process of marking was revised and an objective, mechanical approach of marking to a benchmark mid-price was adopted.
- 4.70. The Firm's breaches of Principles 2 and 3 resulting from the facts set out above are described at section 5 below (Failings).

Market misconduct

- 4.71. This section (paragraphs 4.71 to 4.77) describes trading at month-end in February 2012. Traders on the SCP sold significant quantities of protection on the IG9 10 year index, in particular on 29 February 2012 (with the majority of the

trading conducted after the close of trading in London and before the end of the trading day in New York). One of the purposes of part of this trading was to “*limit the damage*” to the SCP. This could have been achieved if the market price of the index moved closer to the SCP’s mark.

- 4.72. The position in the IG9 10 year index was the biggest contributor to the profit and loss in the SCP because any change in the price of that index would have a larger impact on the profit and loss than for any other instrument within the portfolio. Traders on the SCP were protection sellers on this index, so a lower price for the index would have a positive effect on their mark to market profit and loss. The price of the IG9 10 year index was quoted by market participants in basis points. Basis points are a unit of measurement for determining value. By Friday, 24 February 2012, a downward movement of one basis point in its price would improve the SCP’s mark to market profit and loss by approximately \$34.7 million.
- 4.73. On Monday, 27 February 2012, traders on the SCP sold an approximately \$1 billion notional amount of the IG9 10 year index, approximately \$2 billion on 28 February and approximately \$7.2 billion on 29 February. Between 27 February and the London close on 29 February, the trades were in general executed at declining prices (ranging from 121 to 113 basis points). After the London close and towards the end of the New York trading day on 29 February, traders on the SCP sold approximately \$4.6 billion worth of protection at a price of 113.5 basis points in under three hours (primarily in response to bids from other market participants).
- 4.74. As at the close of trading on Friday, 24 February 2012 the difference between the market price of the IG9 10 year index (as recorded by Bloomberg) and the mark ascribed by traders on the SCP was 3.19 basis points (118.69 (Bloomberg) vs. 115.5 (SCP)). By close of trading on Wednesday, 29 February 2012, the Bloomberg price had moved from 118.69 to 114.22, a move of 4.47 basis points. The difference between the market price (as recorded by Bloomberg) and the marks was 1.72 basis points (114.22 (Bloomberg) vs. 112.5 (SCP)). This fall in the market price reduced the SCP’s mark to market losses by around \$155 million. Traders on the SCP marked the position at February month-end at 112.5 basis points. The difference between the market price and the marks reduced by \$51 million.

4.75. The Authority considers that one of the purposes of part of this trading was to “*limit the damage*” to the SCP. This could have been achieved if the market price of the index moved closer to the SCP’s mark, for the following reasons:

- (a) The size and timing of the trading was such that there was a potential to affect the market price at month-end. The Firm calculated that during the month of February 2012 the notional volume of trading in the IG9 10 year index by the entire market was approximately \$48 billion. The sales by the SCP on 29 February therefore accounted for a significant amount of that total (circa 15%) and approximately three times the average daily volume.
- (b) The size and timing of the trading could have contributed to the month end price of the IG9 10 year index being at a lower level than it would otherwise have been.
- (c) The trading after the London close on 29 February departed from the pre-existing strategy. In simplified terms, one of the strategies for the SCP in 2012 had been to sell protection on the IG9 10 year index to fund the purchase of protection on high yield indices. The trading after the London close on 29 February involved selling the IG9 10 year index outright, without corresponding purchases on the high yield, leaving the book unbalanced. This trading caused a further breach of the CS01 limit.
- (d) There was a potential benefit to the SCP in that the trading could have ensured the market price of the IG9 10 year index was maintained at levels closer to the SCP’s own mark. A one basis point move in the price would have benefitted the SCP by \$37.3 million on 29 February 2012.
- (e) In an email to SCP management, traders on the SCP described the purpose of the trading on 29 February as follows:

“[We] have sold important amounts of protection in IG9 10 year (close to 7 bln all day...) and this will push the CS01 beyond the \$25 million limit. This was related to month end price moves that were all adverse, although we could limit the damage”.

- 4.76. The Authority concludes that at month-end in February 2012, traders on the SCP (with the knowledge of SCP management) entered into transactions on the IG9 10 year index, in particular on 29 February 2012. One of the purposes of part of this trading was to "*limit the damage*" to the SCP. This could have been achieved if the market price of the index moved closer to the SCP's mark. The size of positions meant that a small movement in price had a large effect on the profit and loss position. The size and manner of the trading had the potential to affect the price of the IG9 10 year index at a time when the SCP stood to benefit from a lower price. Taken as a whole this constituted a failure to observe proper standards of market conduct.
- 4.77. The Firm's breach of Principle 5 resulting from this trading is described in section 5 below (Failings).

Valuation control flaws

- 4.78. The losses concealed on the SCP should have been discovered by the month-end valuation control process in place, had it functioned properly in the first quarter of 2012. This section (paragraphs 4.78 to 4.98) describes the flaws in the valuation control process carried out by CIO VCG, which contributed to the escalating losses on the SCP in 2012 not being discovered sooner.
- 4.79. At month-end the marks used by traders on the SCP were assessed by CIO VCG. The role of CIO VCG was to ensure that the positions held by CIO were marked at fair value at the end of each month in accordance with US GAAP. This consisted of ensuring that positions were marked at an observable market rate within an applicable threshold.
- 4.80. CIO VCG was under-resourced, its written policies were not consistently implemented and its regular procedures inadequate. CIO VCG was staffed by two individuals, one of whom had responsibility for all portfolios other than the Asia portfolio. The resourcing issue was raised a number of times with management in CIO VCG between December 2011 and March 2012, but no budget was made available. The resourcing issue was more acute during 2012 due to absence of adequate supervision. This was at a time when the size and complexity of the book was increasing.
- 4.81. The SCP was one of a number of portfolios verified by that individual at the end of each month. He had previously worked as a trader and had been responsible for marking interest rate derivatives products, however he had received no formal

training in relation to his valuation control role. The same individual created all policies and procedures specific to CIO that were relevant to the role he fulfilled. In so doing, he had adapted certain of the procedures relevant to the Firm's Investment Bank. Certain of these policies and adapted procedures were not reviewed or approved by management within CIO VCG.

- 4.82. However CIO Senior Management had approved the internal document authorising the trading of credit derivatives in CIO in 2006 (the new business initiative). This set out that CIO was to have regard to the Group's Investment Bank's valuations over commonly held positions. A further document dating from 2010 set out that the preferred approach in valuing CIO's positions was to use independent prices from sources such as Markit and Totem but also noted that Investment Bank data "*formed a subset of the data used in the price testing process*". In fact CIO VCG did not have regard to the Investment Bank's price testing data as one of the sources of information it considered in the price testing process.
- 4.83. There were other problems with the implementation of CIO VCG's policies in respect of the SCP. The first stage in the month-end verification process was to obtain pricing data for the SCP's transactions from CIO's systems. CIO VCG needed to manually copy this data into its own price testing spreadsheet row by row. This resulted in data entry errors.
- 4.84. In sourcing inputs to demonstrate observable market rates for the SCP, CIO VCG was susceptible to influence from information supplied by traders on the SCP. CIO VCG would speak to traders on the SCP prior to month-end to obtain market colour. CIO VCG would also discuss the results of its price testing with traders on the SCP, including proposed adjustments. If traders felt any of the independent prices were incorrect, they would provide further evidence, for example additional broker quotes, in order to "*justify*" their marks. CIO VCG did not automatically accept the additional quotes, save where the broker quotes reflected a recently traded price for a product. The Authority has seen no evidence that CIO VCG would challenge traders on the SCP as to why other broker quotes provided were a better demonstration of observable market rates than the independent prices sourced by CIO VCG.
- 4.85. For the February 2012 valuation, prices from 1 March 2012 were supplied by traders on the SCP and used by CIO VCG, even though this was after the month-end. This was the point at which the market prices were the most favourable to

the SCP's positions. This reflected a lack of consistency in how CIO VCG was determining its independent price, although CIO VCG was of the view that in a volatile market at the end of the month, the next day's opening prices could be a more accurate reflection of where the market had finished. In addition (as set out at paragraph 4.61), the control process performed by CIO VCG was subverted at February 2012 month-end as a result of improper trader influence.

- 4.86. CIO VCG routinely obtained independent prices for indices from Markit, (an independent third party pricing service). CIO VCG would obtain independent prices from Markit, but to the extent that additional evidence was provided by traders on the SCP it could be used by CIO VCG to overwrite the Markit price and replace it with one of the trader supplied broker prices in the price testing spreadsheet.
- 4.87. An average of broker quotes was used for tranche pricing. When additional evidence was provided by traders on the SCP it could be included by CIO VCG in the averaging process. An independent third party data source for tranche prices (Totem) was available on the third business day of the month in relation to the previous month's prices. Given the interest of CIO London management and CIO Senior Management in the SCP's results, which fed directly into the Firm's earnings, CIO VCG was required to complete its price testing process prior to the publication of Totem prices. Therefore CIO VCG did not consider Totem's tranche pricing in its verification process but would use it after the event to check the sense of its conclusions.
- 4.88. The flaws in the CIO VCG process and their implementation became far more problematic in the first quarter of 2012, given the increased size and complexity of the SCP at that time. Some of those flaws existed prior to the first quarter of 2012. Certain of the flaws in the CIO VCG process were present from 2007. In particular, there was no specific valuation training provided to the relevant individual who had been in position since that time. The process was a highly manual one and therefore inherently susceptible to data entry problems. Relevant skills and experience held by the Firm's Investment Bank in valuing complex products were not routinely utilised.
- 4.89. Guidance had been sent to the Firm by the Authority in August 2008 arising from a number of material mismarking incidents at other firms (the "Dear CEO letter"). The Dear CEO letter set out a list of underlying causes that should be addressed to reduce the likelihood of future mismarking incidents. In particular, these

included that product control staff were unable to challenge front office staff adequately, through lack of skills or seniority, acting too much as a business facilitation function and not enough as a control function. It also referred to independent price verification processes being highly manual, leading to insufficient time and resource to analyse and investigate valuation issues fully and to exercise judgement and challenge front office valuations.

- 4.90. These issues were present in CIO VCG, and were not addressed even after the Dear CEO letter was sent to the Firm. Further to the Dear CEO letter, the Authority undertook thematic work in 2010 which sought to evaluate firms' progress in implementing relevant changes. The Authority's initial observations as regards the Firm's approach to valuation included that there was a manual valuation control process with heavy spreadsheet reliance, valuation policy left much to the subjective assessment of individuals performing the month-end valuations and there was no procedure for ensuring consistency in valuation approach between different lines of business.
- 4.91. As a result, the Firm introduced a "Product Champion Initiative", which sought to create consistency with respect to the valuation of products and price testing, and to the extent that inconsistencies existed, to determine why there was an alternative approach and to obtain agreement from the relevant market maker within the Firm that the alternative approach was justifiable. The relevant market maker for credit derivatives was the Firm's Investment Bank. The Product Champion Initiative was never completed in relation to credit derivatives; however the known differences between CIO VCG and the Firm's market maker were not viewed as material by the Firm. The Firm also relied on their auditors' year-end testing of CIO VCG in December 2011. A new consistency exercise began in 2012. As a result of the Product Champion Initiative, CIO VCG learned that the Investment Bank utilised thresholds in its valuation process. This led CIO VCG to introduce threshold adjustments into its own process in 2011.

The introduction of thresholds

- 4.92. A change to the CIO VCG process was made in early 2011. At that time a threshold adjustment process was introduced. Although the Firm did not realise at the time, the implementation of this process was also fundamentally flawed and the effect of its application contributed to the failure to detect mismarking in a timely fashion in the first quarter of 2012.

- 4.93. From early 2011, CIO VCG would compare the SCP's prices to its independent price and then consider whether CIO's price fell within a threshold from the independent price. If CIO's price fell outside the threshold, an adjustment would be made to bring the price to the boundary of the threshold. CIO VCG endeavoured to base the threshold on bid-ask spreads observed from broker quotes. However, prior to March 2012, the thresholds were not documented, and it is unclear whether the thresholds used reflected proper parameters based on the bid-ask spread. In retrospect, between early 2011 and March 2012, CIO VCG *"in effect eyeballed each price difference to ascertain whether [CIO VCG] felt it was within what [CIO VCG] believed to be a market threshold"*.
- 4.94. CIO VCG management failed to deal adequately with warning signs raised at March 2012 month-end. Specifically, CIO VCG had informed CIO VCG management that the SCP's marks had migrated to the more aggressive (and beneficial) end of the bid-ask spread whilst verifying the March month-end marks. In addition CIO VCG management were aware of the findings of an Internal Audit report dated 30 March 2012. Internal Audit had made a number of findings relating to CIO VCG, some of which were relevant to the verification of marks on the SCP. Although action plans were in place to improve processes for future months, no additional scrutiny of the March month-end valuation process was undertaken by CIO Finance or CIO VCG management prior to the Group's earnings announcement on 13 April 2012.
- 4.95. One of Internal Audit's findings which was relevant to the SCP was that CIO VCG's thresholds were not *"formally documented"* or *"consistently applied"* and that they were applied without *"sufficient transparency or evidence"*. This finding led CIO VCG to make amendments to the March month-end process (the draft Internal Audit report having been considered prior to month-end). However, a lack of scrutiny by the management of CIO VCG around these changes led to further problems.
- 4.96. The thresholds were documented to some extent in March 2012 however they were wrongly applied. The CIO VCG threshold (which was supposed to reflect parameters based on the bid-ask spread) was applied from the independent mid-price rather than the bid or ask price. In some circumstances this had the effect of doubling the width of the threshold.
- 4.97. CIO VCG's proposed adjustments following completion of the price testing process would be discussed by CIO VCG with SCP management. In relation to the month-

end price testing process for March 2012, SCP management expressed the view that the proposed adjustment was unnecessary owing to market volatility which meant the prices received did not reflect true market prices. Following this conversation, CIO VCG considered and amended one of the thresholds used (which by this time had been documented) and as a result no proposed adjustment was made to that position.

- 4.98. The Firm's breaches of the Principles relating to the flaws in its valuation control process are set out at section 5 below (Failings). Without these flaws, the mismarking of the SCP may have been detected earlier.

Opportunities to question valuation

- 4.99. Flaws in the CIO VCG process, amongst other things, prevented the early discovery of the mismarking. However, even where other warning signs were present, the Firm did not take the opportunity to ask all of the relevant questions. This section (paragraphs 4.99 to 4.103) sets out that there were several indications available to CIO Senior Management that there may have been problems with the marking and valuation of the SCP at March month-end.

- 4.100. During March 2012, traders on the SCP and SCP management had become increasingly paranoid that losses were arising because market participants were giving indicative prices to CIO which were not representative of the price at which the market participants were in fact willing to transact. Traders on the SCP and SCP management believed that the Investment Bank had been leaking their positions to the market and deliberately "*framing*" prices against them (a subsequent investigation by Compliance in London concluded this belief was erroneous).

- 4.101. In mid-March 2012, as the SCP failed to reduce its RWA, CIO London management suggested offsetting some of the risk of the positions either with the Investment Bank or a third party. This was a cause for concern to traders on the SCP, who were aware that the Investment Bank was counterparty to some of their positions. SCP management explained in an email to CIO Senior Management the belief that the settling of these positions with the Investment Bank would cause a "*permanent loss*" to the SCP of around \$350 million, because each side of the trade would have to agree a price. This email should have caused CIO Senior Management to seek to understand whether there was a price variance within the Firm of around \$350 million (where the SCP and the Investment Bank held the opposite sides of the same trades) and if so, the reason

for the variance. However CIO Senior Management missed this opportunity to seek further information, believing the matter to relate to paranoia about the Investment Bank. CIO London management contacted the Investment Bank to complain about the allegation of leaking prices. On hearing the allegations an individual at the Investment Bank immediately identified that there might be a mismarking issue at the heart of the dispute saying:

"what I see is an accusation that the Investment Bank, with someone leaking the position of CIO, is acting against CIO [and] mismarking the books to damage CIO"

He noted that if CIO's allegation was true he would need to "fire a lot of people" and stated that he would ask his senior valuation team "to take a look [at] the marks and see if there is anything that is being done inappropriate". This reaction should have prompted CIO London management to make sure CIO's house was in order from a marking perspective. A logical inference to be drawn from the situation, if the Investment Bank's marks were correct, was that the mismarking problem may lie with CIO. However CIO London management did not take further action, assuming that the problem lay with the Investment Bank.

4.102. Following the publication of the Wall Street Journal article on 6 April 2012, the Firm's Senior Management requested a "*full diagnostic*" on the SCP by Monday 9 April. CIO London management informed CIO Senior Management that they were unsure how big the losses in the SCP might be at the end of the second quarter, because the figure was "*highly dependent on the marks*". CIO Senior Management were later told by SCP management that the losses should not exceed \$200 million "*if we exclude very adverse marks to our book*". This email should have heightened CIO Senior Management's focus on how the SCP was being marked because it highlighted the subjectivity in the SCP's marking process given the nature of the instruments and reminded CIO Senior Management of how crucial the marks were to the SCP's profitability or lack thereof.

4.103. The Firm's breach of Principle 2 relating to these missed opportunities is set out at section 5 below (Failings). In the Authority's view, if managers within CIO had asked further questions in connection with these communications, they may have identified the mismarking of the SCP earlier.

Firm Senior Management's response

- 4.104. It was only in late April 2012, when CIO's positions began to feature heavily in large collateral disputes involving the Firm and substantial losses were accruing in the portfolio, that the Firm began to consider in detail the valuation processes in the SCP.
- 4.105. By 20 April 2012 there were 14 collateral disputes where the SCP had marked its positions more favourably than its counterparties. Significantly, one counterparty made clear to the collateral management team and CIO VCG that the dispute was only in respect of the valuation of credit derivative positions held within CIO and not in respect of any credit derivative positions held by the Group's Investment Bank (whose valuations were "*very much in line*" with those of the counterparty). This again highlighted to the Firm that there was a difference in valuation methodology between the Investment Bank and CIO, and on this occasion it was clear that the valuation problems lay with CIO.
- 4.106. As a result of the collateral disputes and the further escalating losses, the Firm's Senior Management began a valuation validation review, which included setting up a number of different work streams to gather and analyse information about the valuations and valuation processes of the SCP (in addition to considering risk issues). This section (paragraphs 4.104 to 4.126) describes the work undertaken as part of that exercise, the problems with certain aspects of the work streams and the Firm's flawed judgement in its evaluation of the information gathered.
- 4.107. In establishing the valuation validation exercise, various work streams were put into place including:
- (a) a price comparison exercise which ascertained the valuation the Group's Investment Bank would have applied to the SCP's positions, had they been valued using the Investment Bank's own VCG methodology;
 - (b) a review, conducted by the Corporate Controller's office, of the valuations assigned by traders and CIO VCG to the positions in the SCP at March 2012 month-end; and
 - (c) a further review by Internal Audit of the consistency of CIO VCG's approach to the SCP between September 2011 and March 2012.

The Investment Bank's price comparison

- 4.108. The price comparison exercise undertaken by the Investment Bank was conducted by the Investment Bank's Valuation Control Group ("IB VCG"). IB VCG took each position within the SCP and ran it through the Investment Bank's valuation control processes. IB VCG concluded that the SCP had been marked at least \$767 million more favourably than it would have been valued by IB VCG. When IB VCG compared the SCP's marks to the bid-ask spread that IB VCG had extrapolated for the positions, they estimated that six positions, some of which were the SCP's largest, were marked outside of those spreads.
- 4.109. The results of the IB VCG comparison exercise were shared with the Firm's Senior Management on 28 April 2012. In the run up to 10 May 2012, IB VCG were concerned to ensure that Firm Senior Management understood the reliability of the price comparison exercise they had undertaken. IB VCG reminded Senior Management that the application of thresholds differed substantially between the IB VCG and CIO VCG and that the quality of the price discovery mechanisms used by IB VCG were very good. IB VCG also notified the Firm's Senior Management that IB VCG could not recall an adjustment greater than \$50 million being made across the entirety of the Investment Bank's positions.

The review by the Corporate Controller's office

- 4.110. The Corporate Controller's office carried out a review to analyse whether the valuation of the SCP at March month-end was compliant with US GAAP ("the review by the Controller's office"). The analysis involved a review of the process used within CIO to value positions. The Corporate Controller's office included the Corporate Accounting Policy function, which was responsible for advising on accounting matters, including the accurate fair value accounting treatment of complex products.
- 4.111. The review by the Controller's office used information obtained from traders on the SCP, SCP management, CIO VCG and CIO Finance. The analysis noted that although the month-end marks for 30 March 2012 were aggressive relative to the bid-ask spread, they were predominately within the thresholds used by CIO VCG and were within the range of reasonable fair values for the instruments in question. As a result, the analysis concluded the marks were consistent with US GAAP.
- 4.112. There were flaws in the review by the Controller's office. First, it relied on explanations for the valuations provided by traders on the SCP, including the

timing difference between the close of the London and New York markets, general market volatility in late March and early April, intra-day volatility which was said to cause significant differences between maximum and minimum prices, dislocation in the market, and a lack of confidence as to how independent consensus pricing was determined. In retrospect the reliance placed on the traders' explanations was too great.

4.113. Second, the review by the Controller's office relied on CIO VCG's determination that there was a difference of around \$275 million between CIO VCG's independent prices and the SCP's prices. This calculation was done by CIO VCG at the direction of CIO Senior Management and was based on a spreadsheet which CIO VCG had used in its valuation process in March 2012. On 9 May 2012, the day before the Regulatory Filing, it was identified that there was a "*signage error*" in CIO VCG's spreadsheet calculation, meaning that certain cells had a plus rather than a minus number. The resulting recalculation meant that the difference grew to \$512 million. This error, identified late in the proceedings, gave the Controller's office pause for thought regarding the reliance they were placing on the work of CIO VCG. Ultimately the Controller's office concluded that no further work was necessary.

4.114. Third, the review failed to understand adequately errors in the application of thresholds used by CIO VCG. The review was provided with information about the application of thresholds by CIO Finance. After the collateral disputes issue had arisen, CIO VCG and CIO VCG management had documented certain procedures relating to the month-end price testing process. CIO VCG's approach to thresholds was set out in a document shared with CIO Finance and the review by the Controller's office. The explanation was poorly worded and ambiguous as to how the thresholds were applied. However detailed analysis of the document could have revealed that the process was inconsistent, the most acute problem being that overly wide thresholds were being applied.

4.115. CIO Finance and Firm Senior Management were aware that CIO VCG's thresholds were wide. CIO Finance also knew that for March month-end, the estimated difference between SCP prices and CIO VCG's independent prices was around \$200 million prior to the application of the thresholds and that after the thresholds were applied the adjustment was only \$17 million. Whilst the review by the Controller's office was underway, CIO Finance requested analyses illustrating the effect on the CIO VCG process if certain alterations were made to the thresholds. This included a request for the size of the adjustment if the

thresholds were narrowed by half, a second request to anchor the CIO VCG threshold from the bid or offer (i.e. around the CIO VCG price rather than on one side), and a further request for the size of the adjustment if a maximum dollar amount threshold was applied, as it was by IB VCG. The expectation of CIO VCG management was that the effect of narrowing the thresholds by half would be to increase the amount of the CIO VCG adjustment.

4.116. However, despite this knowledge, concerns about the thresholds being wide were not explained in the review by the Controller's office. The review noted that the thresholds were consistent from 31 December 2011 to 31 March 2012, in contrast to the findings of Internal Audit, who had noted that there were not formally documented and inconsistently applied price testing thresholds.

4.117. Fourth, the review by the Controller's office set out in its appendices that the marks applied to the SCP had migrated from at or near the mid-point at month-end January 2012 to the favourable end of the bid-ask spread by month-end March 2012, with one position marked outside the bid-ask spread as a result of a front office data entry error. The review did not address this migration of the marks in narrative form at all and failed to analyse the potential reasons for this migration, not connecting the snowballing losses in the SCP with the migration of the marks. Those conducting the review and the member of Firm Senior Management responsible for commissioning the work stream directly asked SCP management whether the SCP had been marked with a bias towards the most favourable prices and received a reassuring response.

Internal Audit's review

4.118. As described at paragraph 4.94 above, Internal Audit had already carried out a review of CIO VCG's practices, including those relating to the SCP and its findings were summarised in a report dated 30 March 2012. Key findings were also presented to Firm Senior Management in the form of an Executive Management Report. Both reports noted that there were several deficiencies in the process, including that the thresholds used in verifying the marks in the SCP were not formally documented and not consistently applied. Both reports were considered by the Firm's Senior Management in the run up to the Regulatory Filing.

4.119. In addition to the 30 March Internal Audit report, the Firm's Senior Management asked that Internal Audit carry out a further review of the consistency of CIO VCG's approach to the SCP between September 2011 and March 2012. Internal

Audit tested the SCP's prices and thresholds against independent sources. Internal Audit's memo stated that:

- (a) There was a lack of documentation supporting the price testing process in CIO.
- (b) There were problems with the thresholds applied; CIO VCG thresholds were, in most cases, much larger than Internal Audit's thresholds because CIO VCG was, in many cases, taking a complete bid-ask spread rather than the more appropriate measure of half of the bid-ask spread. For example, in relation to the IG9 10 year positions, Internal Audit determined the appropriate threshold to be 0.75, but CIO VCG had applied a threshold of 4.00 – over four times wider than that of Internal Audit.
- (c) On occasions within the period Internal Audit were considering CIO VCG had over-written its independent price.
- (d) There were manual data entry errors. These were caused by the labour intensive process used by CIO VCG, as described above.

4.120. Internal Audit concluded that had CIO VCG applied the thresholds appropriately, the SCP positions should have been adjusted by \$307 million rather than the \$17 million adjustment made by CIO VCG at March month-end.

4.121. Internal Audit did not escalate the observations set out above to Firm Senior Management. Firm Senior Management proceeded on the understanding that what Internal Audit had found went no further than the conclusions reached in their report dated 30 March 2012 where they noted that CIO VCG's processes needed improvement.

Evaluation of the work streams

4.122. Prior to the Regulatory Filing being made, meetings were held, with a final meeting on 10 May 2012 attended by the Firm's Senior Management and all relevant senior personnel responsible for the above reviews. Each responsible individual was asked to confirm there were no issues to prevent the Regulatory Filing being made. The tone of these discussions was summarised by Jamie Dimon as follows:

"I sat in those meetings myself and said: believe that the Pope is over here and the [Chairwoman] of the Securities Commission is over here, what is the right thing to do?"

4.123. By that meeting, the collective knowledge in the Firm included the following facts which should, if known by the Firm's Senior Management have led them to question further whether the March month-end valuations were sufficiently reliable to support the Regulatory Filing:

- (a) There was a difference of \$767 million between the IB VCG valuation of the SCP's positions and the traders on the SCP's marks.
- (b) There was a difference of \$568 million between Internal Audit's valuation of the SCP's positions and the traders on the SCP's marks.
- (c) Internal Audit identified that, had the thresholds been applied appropriately by CIO VCG, the traders' valuation of the SCP should have been reduced by \$307 million.
- (d) The review by the Controller's office had understood that there was a \$275 million difference between the SCP marks and CIO VCG mid prices pre-adjustment. On 9 May 2012, calculation errors were uncovered in CIO VCG's work and the difference grew to \$512 million.
- (e) There were separate underlying causes for each valuation difference identified by the various work streams. The numerical differences were not all expressing the same problem, but identified a series of issues as being the underlying cause.
- (f) IB VCG had stressed to the Firm's Senior Management that the price discovery mechanisms for the IB VCG process were of high quality.
- (g) Internal Audit had concluded on 30 March 2012 that the price discovery mechanism for the CIO VCG process needed improvement.
- (h) IB VCG had explained to Senior Management that the thresholds applied by IB VCG and CIO VCG were materially different across the two lines of business.

- (i) Internal Audit had explained that the thresholds used by CIO VCG were not formally documented or consistently applied.
- (j) Firm Senior Management were aware that CIO VCG's thresholds were wide.
- (k) The SCP had sustained increasingly severe losses from the start of 2012.
- (l) The SCP's marks had migrated from the mid-point to the aggressive end of the bid-ask spread between January and March 2012.

4.124. The Regulatory Filing was made on the basis that the SCP had been valued by the traders on the SCP and CIO VCG in accordance with US GAAP. Firm Senior Management relied on the conclusions of the review by the Controller's office. However Firm Senior Management gave insufficient weight to inconsistencies raised by the information in its possession, especially in light of the context provided by the scale of losses in the SCP. Other relevant information was not escalated to Firm Senior Management. This was because the work streams operated in silos; those performing the work lacked awareness of the overall context and as a result could not determine what information would be relevant to Firm Senior Management. The Firm's Senior Management should have taken additional steps to ensure that all crucial information reached the appropriate decision makers.

4.125. Had all relevant information been escalated to Firm Senior Management and more effective analysis been undertaken, the Firm might have concluded that the valuation was not sufficiently certain to make the Regulatory Filing. Also, in the Authority's view, the Firm should have given further consideration to whether the SCP had in fact been actively mismarked.

4.126. The Firm's breach of Principle 2 in this regard is set out at section 5 (Failings).

Failure to involve key control functions

4.127. In conducting the valuation validation work streams, the Firm did not include Compliance in London. Had that key control function been involved in the process, a crucial piece of evidence of potential mismarking might have been discovered sooner. The Authority considers that this failure was a disturbing weakness in the review as Compliance forms a key part of the Firm's control framework.

4.128. Firm Senior Management did not inform Compliance in London that there was even a valuation validation exercise being undertaken at all. However, Compliance in London had already reviewed key evidence relevant to the valuation validation exercise. As a result of a complaint by SCP management about the Investment Bank allegedly leaking the SCP's positions to other market participants, prior to 10 May 2012 Compliance in London had listened to a crucial call between traders on the SCP and SCP management, subsequently discovered to be about mismarking in order to conceal losses on the portfolio. Compliance in London had considered the discussion in the call to relate to how losses were being communicated, rather than suggesting that losses were being concealed. Compliance believed the relevant losses discussed in the call had been reported and therefore did not consider the call merited further escalation. Had Compliance in London been informed of the reviews being undertaken in advance of the Regulatory filing it could have brought this evidence to the attention of the relevant work streams at a time when the very subject of the phone calls was being considered by Firm Senior Management.

4.129. Following the Regulatory Filing, the Firm commenced a further review of information relating to the SCP. The Firm commissioned a management task force review into the losses incurred by CIO. This included an extended review of relevant communications and interviews with traders on the SCP and SCP management. When the further reviews commenced after 10 May 2012, Compliance in London were involved and soon after notified the task force review of the relevant telephone call.

4.130. The Authority considers that Firm Senior Management should have included relevant Compliance personnel in London in a review of valuation in the London office. This was a significant failing because, by not doing so, the Firm missed an opportunity to discover mismarking prior to 10 May 2012.

4.131. Firm Senior Management did not inform the Group's Audit Committee of the details of the work undertaken to ascertain the legitimacy of the valuation of the SCP by the Investment Bank or the details of Internal Audit's review. Nor were the Audit Committee made aware of trader involvement in the valuation process or the migration of the marks to the advantageous end of the bid-ask spread.

4.132. The Authority considers that the Firm's failure to keep the Audit Committee and Compliance fully informed was significant. These areas are control functions, with a responsibility to challenge the Firm. Firm Senior Management should have led

by example, by recognising the need for quasi-independent oversight of the Firm's business practices as they related to the problems on the SCP. Compliance could have added vital knowledge to the review process and the Audit Committee could have introduced valuable independent oversight.

Events leading up to restatement

4.133. Although other specialists in the Firm had been asked by Firm Senior Management to review the SCP's valuation process prior to May 10 2012, it was not until June 2012 that an effective and comprehensive review of the marking of the SCP in the first quarter of 2012 took place, after the Firm's discovery of evidence which raised concerns about potential mismarking (see paragraph 4.128 to 4.129). There was a complete examination of the price testing spreadsheet used by CIO VCG revealing additional errors which increased the difference between the SCP's prices and the CIO VCG independent pre-adjusted price from \$512 million to around \$670 million.

4.134. The Firm also interviewed traders on the SCP and SCP management in the period after the Regulatory Filing was made. One trader was interviewed on 14 and 15 June and other relevant personnel were interviewed about the marking process towards the end of June 2012. The results of these interviews together with the documentary and tape recorded evidence led the Firm to conclude that it could not rely on the traders' integrity which compromised the reliability of the marks. When combined with the discovery of further errors in the CIO VCG price testing spreadsheet and concerns raised over the supervision of the CIO VCG process, the Firm came to the conclusion in July 2012 that it was necessary to restate its earnings. The Firm also reported to the U.S. Securities and Exchange Commission a material control weakness within the Firm's internal controls over financial reporting as of 30 March 2012.

Failure to be open and co-operative with the Authority

4.135. This section (paragraphs 4.135 to 4.147) sets out the facts and matters relevant to the Firm's relationship with the Authority. In particular, the Firm did not provide relevant information to the Authority during the first half of 2012 and (by virtue of the conduct of CIO London management) the Authority was deliberately misled on one occasion.

4.136. In addition to the Firm's regulatory obligation to maintain an open and co-operative relationship with the Authority, from 1 October 2010 CIO in London had been the subject of a more detailed supervisory relationship. As a result, on 9

November 2010, the Authority advised the Firm in writing of particular matters relating to CIO about which it wished to be kept informed, *inter alia*:

- (a) any significant growth in assets or change in CIO's Europe, Middle East and Asia portfolios, including the SCP;
- (b) any significant change in CIO's level of risk appetite;
- (c) any material change to portfolio mandates or risk limits allocated to CIO's Europe, Middle East and Asia portfolios, which included the SCP; and
- (d) material changes to CIO's Europe, Middle East and Asia strategy.

4.137. On 28 March 2012, the Firm attended a quarterly supervisory meeting with the Authority. The meeting was attended by various CIO personnel, including SCP management and CIO London management. The SCP was discussed with the Authority as part of a dialogue regarding CIO's London business as a whole.

4.138. When discussing the SCP, those at the meeting did not inform the Authority that:

- (a) CIO Senior Management had ordered traders on the SCP to stop trading: SCP management and CIO London management had received notification by email of this on 26 March 2012.
- (b) The SCP had increased significantly in notional size: information provided to the Authority which dealt with portfolio changes contained no data about the substantial changes in the size of the SCP. Both SCP management and CIO London management had received an email on 27 March 2012 setting out that the total notional size of the SCP on 26 March 2012 was \$131 billion.
- (c) The SCP had suffered \$298 million of losses in the year to date: information provided showed year to date losses of \$170 million for February 2012 month-end and included a forecast of losses of \$221 million by March 2012 month-end. SCP management and CIO London management had received an email on 27 March 2012 indicating that the estimated losses on the SCP to date were in fact \$298 million, a figure which already exceeded the year to date losses provided to the Authority by \$128 million and the estimated losses provided for March month-end by \$70 million.

- (d) The SCP had breached its CS01, VaR and CSW10 risk limits in the first quarter of 2012: SCP management and CIO London management were aware of these breaches in advance of the meeting.
- (e) The reduction in VaR for the SCP was due extensively to the new VaR model: information provided indicated a reduction in average daily mark to market VaR for CIO from approximately \$92 million in January to \$48 million by 16 March 2012. The Authority were not informed that the change in VaR methodology for the SCP was the main driver of the reduction.

4.139. The Authority expected pro-active notification of these matters as part of its on-going supervisory relationship with the Firm and the Firm was obliged to provide it under Principle 11. The Firm's representatives failed to notify the Authority of these matters in the period from January 2012 and in particular at the meeting on 28 March 2012.

4.140. On 10 April 2012, the Firm, based on information provided by CIO London management instigated a discussion with the Authority as a result of the article in the Wall Street Journal. The discussion was initiated by an email stating, *inter alia*:

"we use credit-related instruments to hedge [CIO's portfolios] against a stress credit environment. The activity noted in the story is simply a balancing of those credit-related investments to reduce the impact of our hedge".

4.141. In continuation of that discussion, at 5pm the same day, there was a conference call with the Authority which CIO London management led. The participants on the call gave the Authority the following information:

- (a) There had been no material changes to the SCP since the meeting on 28 March 2012.
- (b) The newspaper articles did not recognise that the SCP's positions in the IG9 index were part of a larger position that was *"broadly a hedge of the firm's exposures outside CIO"*.
- (c) VaR had been reduced from \$115 million in the first quarter of 2009 to \$58 million in April 2012, in part as a result of the IG9 positions

in the SCP. Yet again, those at the meeting did not explain that part of this reduction was attributable to a change in VaR calculation methodology.

4.142. The Authority was not informed that:

- (a) The SCP had suffered adjusted losses of \$705 million in the first quarter of 2012: CIO London management had received an email dated 9 April 2012 providing them with updated loss figures.
- (b) The SCP was expected to lose a significant amount of money that day, such that it would push the year to date losses in the portfolio beyond \$1 billion: CIO London management had received this information from traders on the SCP orally prior to the call.
- (c) The SCP was currently in breach of its stress loss limits: CIO London management was notified of these breaches by email on 4 April 2012.
- (d) The SCP was considered by CIO London management to be "*in crisis mode*" and parts of the SCP's trading strategy had resulted in the SCP having "*almost total loss of hedging effectiveness*".

4.143. The Authority considers that the tone of the call was deliberately reassuring; CIO London management must have appreciated that by not providing the information set out above, the message delivered to the Authority was not an accurate reflection of the state of the SCP. As a result the Authority has concluded that (by virtue of the conduct of CIO London management) the Authority was deliberately misled by the Firm.

4.144. On 14 May 2012, the Firm again met with the Authority to discuss the SCP. The meeting was attended by members of the new CIO management team who advised the Authority of the new management changes and some of the matters which had not been previously disclosed. However, the Firm did not inform the Authority of any of the valuation validation work streams undertaken for the purposes of the Regulatory Filing, as they mistakenly believed the issues to have been resolved.

4.145. On 23 May 2012, the Authority informed the Firm that its "*appetite for further surprises was close to zero*". In late May and early June the Authority continued to meet with the Firm to discuss the SCP. Many of the meetings related to

ensuring that the risks inherent in the portfolio were being adequately controlled. As to valuation issues, in a meeting on 6 June, the Firm indicated to the Authority that traders on the SCP had been "*marking to where they observed*". In response to enquiries regarding consistency between the SCP's marks and those of the Investment Bank, the Firm indicated that the marks for like-for-like products "*were not far off*". The Authority considers that in light of its appetite for surprises at that time the Firm should have informed it of the results of the valuation validation work streams including that a significant difference between the SCP marks and IB VCG's aggregate valuation of the SCP had been identified (see paragraph 4.108).

4.146. On 20 June 2012 Firm Senior Management met with the Authority to discuss the Firm's internal investigation into CIO. By this stage, the Firm's task force review committee had been notified of potential problems regarding marking within the SCP (including the evidence noted by Compliance in London and referred to at paragraph 4.128), and the Firm's legal advisors had begun to conduct interviews with traders on the SCP. During the meeting, Firm Senior Management discussed the marking process for the SCP, but gave no indication that the Firm were by now questioning the veracity of the marks, and that Firm Senior Management were aware of some evidence indicating potentially serious misconduct by individuals approved by the Authority.

4.147. On 2 July 2012, the Firm informed the Authority that it had identified evidence that caused it to have concerns about the integrity of the marks in the SCP. During 9 and 10 July, the Firm informed the Authority of the understatement of loss in the Regulatory Filing and indicated that the Group was analysing whether it would be restating the Firm's first quarter earnings. It subsequently did make a restatement on 13 July 2012.

5. FAILINGS

5.1. The regulatory provisions relevant to this Warning Notice are referred to in Annex A.

5.2. In assessing the Firm's failings, the Authority has had regard to its strategic objective of ensuring that the financial markets function well, and its integrity objective. The integrity objective is protecting and enhancing the integrity of the UK financial system, including by seeking to ensure:

- (a) its soundness, reliability and resilience;

- (b) the orderly operation of the financial markets; and
- (c) the transparency of the price formation process in those markets.

Principle 2

- 5.3. Principle 2 of the Principles for Businesses states that a firm must conduct its business with due skill, care and diligence.
- 5.4. In breach of Principle 2 the Firm has not conducted its business with due skill, care and diligence by virtue of:
 - (a) The Firm's failure to manage appropriately the trading strategy for the SCP (in the first quarter of 2012). The Authority agrees with the Firm's characterisation of the SCP's trading strategy as "*flawed, complex, poorly reviewed, poorly executed and poorly monitored*" (see paragraphs to 4.10 to 4.29).
 - (b) The Firm's inadequate response to the indicators of increasing risk in the SCP (in the first quarter of 2012). To the extent that adequate systems and controls existed to measure risk, the Firm's response to the indicators of increasing risk in the SCP was wholly insufficient (see paragraphs 4.30 to 4.54). The Authority considers that the Firm's attitude to risk management in CIO lacked sufficient care, as demonstrated by the Firm's response to risk limit breaches in 2012 referred to at paragraph 4.53 above.
 - (c) The Firm failed to price certain positions held in the SCP accurately and failed to prevent or detect mismarking in a timely manner (in the first quarter of 2012) (see paragraphs 4.55 to 4.70 and 4.78 to 4.98) as a result of:
 - (i) the subversion of the valuation control process in February 2012 by the traders on the SCP;
 - (ii) the traders on the SCP and SCP management concealing losses; and
 - (iii) a flawed valuation process (see paragraphs 4.78 to 4.98 and Principle 3 below).

- (d) Weaknesses in assessing the reliability of the valuation of the SCP (in late April and early May 2012) (see paragraphs 4.104 to 4.132). In particular, the Firm's conclusion that the valuation of the SCP was reliable and the failure to involve relevant control groups in the co-ordination of the Firm's response.

Principle 3

- 5.5. Principle 3 of the Principles for Businesses states that a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
- 5.6. In breach of Principle 3 the Firm has not taken reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems by virtue of:

Valuation processes

- (a) The Firm's failure to ensure its marking and valuation processes were effective which contributed to the escalating losses on the SCP not being discovered sooner, and led the Firm to restate its first quarter net income (see paragraphs 4.78 to 4.98). The Authority considers that an effective month-end price verification process is critical in ensuring the appropriate marking of trading books, and in seeking to prevent or detect mismarking.
- (b) In particular, the Firm from 2007:
 - (i) failed to provide traders on the SCP with any formal training, guidance or documented policy as to how the Firm expected them to mark their positions;
 - (ii) failed to provide formal valuation training for CIO VCG;
 - (iii) placed over-reliance on highly manual processes; and
 - (iv) failed to utilise relevant skills and experience in the valuation of complex products held by other lines of business in the Firm.
- (c) The Firm, from 2011:

- (i) failed to ensure that changes introduced to the CIO VCG process were implemented appropriately, adequately documented and consistently applied.
- (d) The Firm, from 2012:
 - (i) failed to ensure CIO VCG was adequately resourced, given the increasing size and complexity of the SCP;
 - (ii) failed to ensure CIO VCG was operating with adequate supervision, given the increasing size and complexity of the SCP; and
 - (iii) failed to prevent calculation errors within the spreadsheet used to price test the SCP.

Risk management systems

- (e) The Firm's flawed approach to the measurement of risk within the SCP, as demonstrated by the errors in the new VaR model, meant that it failed to ensure it had adequate and effective systems to monitor risk within the SCP (from January 2012) (see paragraphs 4.30 to 4.54).

Principle 5

- 5.7. Principle 5 of the Principles for Businesses states that a firm must observe proper standards of market conduct.
- 5.8. By virtue of the actions of traders on the SCP and with the knowledge of SCP management, on 29 February 2012, the Firm engaged in a substantial amount of trading by selling protection on the IG9 10 year index. The Authority considers that one of the purposes of part of this trading was to "*limit the damage*" to the SCP. This could have been achieved if the market price of the index moved closer to the SCP's mark. The size and manner of the trading had the potential to affect the price of the IG9 10 year index at a time when the SCP stood to benefit from a lower price (see paragraphs 4.71 to 4.77). As a result of these matters the Firm failed to observe proper standards of market conduct.

Principle 11

- 5.9. Principle 11 of the Principles for Businesses states that a firm must deal with its regulators in an open and cooperative way, and must disclose to the Authority

anything relating to the firm of which the Authority would reasonably expect notice.

5.10. Between January 2012 until 2 July 2012 the Firm breached Principle 11 by failing to deal with the Authority in an open and co-operative way (see paragraphs 4.135 to 4.147). In particular the Firm:

- (a) should have proactively notified the Authority as problems arose within the SCP. On 28 March 2012 the Firm provided incomplete information to the Authority regarding the SCP.
- (b) by virtue of the conduct of CIO London management deliberately misled the Authority about the situation within the SCP on 10 April 2012.
- (c) did not inform the Authority of the details of significant and serious problems and events in relation to the SCP until 14 May 2012.
- (d) did not inform the Authority of the fact of its extensive valuation reviews until 2 July 2012.

5.11. The Principle 11 breach is aggravated by the fact that the Firm was subject to a more detailed supervisory relationship with the Authority at the relevant time.

Conclusion

5.12. The failings set out above are particularly serious because they demonstrate shortcomings from the SCP traders through to Firm Senior Management. Further, there were multiple issues and breaches, including flaws in the CIO VCG process, that pre-existed the problems in the first quarter of 2012.

5.13. By failing to manage appropriately the trading strategy, failing to monitor and manage risk suitably, failing to carry out adequate valuations and failing to act in accordance with proper standards of market conduct, the Firm created a risk to the integrity of the UK financial system. Poor conduct by firms operating in the UK can affect the integrity of the markets. Financial institutions and consumers need to trust that the UK markets are sound, stable and resilient. The Firm's failings had the potential to put in jeopardy the soundness and stability of UK financial markets and undermined trust and confidence in those markets.

5.14. This was compounded by the Firm's failure to be open and cooperative with the Authority. Timely and proactive communication with the Authority is of

fundamental importance to the proper functioning of the regulatory system. This is all the more true for systemically important firms, such as the Firm.

6. SANCTION

6.1. The Authority's policy for imposing a financial penalty is set out in Chapter 6 of the Authority's Decision Procedure and Penalties Manual ("DEPP"). Changes to DEPP were introduced on 6 March 2010. Given that the Firm's misconduct occurred both before and after that date, the Authority has had regard to the provisions of DEPP in force before and after that date. The Authority has also had regard to the provisions of the Enforcement manual in force prior to 28 August 2007, in relation to misconduct which occurred prior to that date.

6.2. Set out below is the application of the Authority's penalty policy in relation to:

- (a) the Firm's breach of Principle 3 prior to 6 March 2010;
- (b) the Firm's breaches of Principles 2, 3 and 5 on or after 6 March 2010; and
- (c) the Firm's breach of Principle 11.

Breach of Principle 3 prior to 6 March 2010

6.3. In determining the financial penalty to be attributed to the Firm's misconduct prior to 6 March 2010, the Authority has had particular regard to the following:

- (a) The principal purpose of a financial penalty is to promote high standards of regulatory conduct by deterring firms who have breached regulatory requirements from committing further contraventions, helping to deter other firms from committing contraventions and demonstrating generally to firms the benefits of compliant behaviour (DEPP 6.1.2G in force prior to 6 March 2010).
- (b) The nature, seriousness and impact of the breach. In particular, in respect of certain of the flaws in the application of controls relating to the marking and valuation of products in the SCP, the Firm's breach occurred for three years prior to 6 March 2010. Market confidence is put at risk by valuation inaccuracies (DEPP 6.5.2G(2) in force prior to 6 March 2010).

- (c) The size and resources of the Firm. The Firm is a major international financial institution and should have had systems and controls commensurate with the requirement to supervise adequately the complex products traded by the SCP, in particular as the size of the SCP grew. The revenue generated by the SCP alone in the period from 2007 to 2009 was over \$1.46 billion (DEPP 6.5.2G(5)(c) and (d) in force prior to 6 March 2010).
- (d) Other action taken by the Authority. The Authority published a number of Final Notices relating to mismarking and other general guidance (including the Dear CEO letter) dealing with similar issues in the same period. The Authority also gave the Firm specific guidance around valuation issues in the same period. Despite these previous actions and published guidance, the Authority has seen no evidence that relevant changes were made by the Firm to the marking and valuation processes relevant to the SCP (DEPP 6.5.2G(10) and (12) in force prior to 6 March 2010).

- 6.4. The Authority considers that the Firm's breach of Principle 3 in the period prior to 6 March 2010 merits a significant financial penalty of £20,000,000.
- 6.5. The Firm agreed to settle at an early stage of the Authority's investigation. The Firm therefore qualified for a 30% (stage 1) discount under the Authority's executive settlement procedures. The financial penalty for the Firm's breach of Principle 3 in the prior period to 6 March 2012 is therefore £14,000,000.

Breaches of Principles 2, 3 and 5 on or after 6 March 2010

- 6.6. In respect of conduct occurring on or after 6 March 2010, the Authority applies a five-step framework to determine the appropriate level of financial penalty. DEPP 6.5A sets out the details of the five-step framework that applies in respect of financial penalties imposed on firms.
- 6.7. The Authority considers that the breaches of Principles 2, 3 and 5 occurring after 6 March 2010 arise from a single course of conduct by the Firm. In the particular circumstances of this case, the Authority has concluded that it is appropriate to impose a combined penalty in respect of these breaches. The Firm's failings in the SCP and CIO VCG permitted the concealment of losses through both mismarking and market misconduct.

Step 1: disgorgement

- 6.8. At Step 1 the Authority seeks to deprive a firm of the financial benefit derived directly from the breach where it is practicable to quantify this (DEPP 6.5A.1G). The Authority has not identified any financial benefit that the Firm derived directly from its breaches.
- 6.9. Step 1 is therefore £0.

Step 2: the seriousness of the breach

- 6.10. At Step 2 the Authority determines a figure that reflects the seriousness of the breach (DEPP 6.5A.2G). Where the amount of revenue generated by a firm from a particular product line or business area is indicative of the harm or potential harm that its breach may cause, that figure will be based on a percentage of the firm's revenue from the relevant products or business area.
- 6.11. The Authority considers revenue generated by the SCP to be indicative of the harm or potential harm caused by its breach. The Authority considers that the relevant revenue for the breach of Principle 3 occurring between 6 March 2010 and 31 December 2011 is £357,088,000. The Authority considers that the relevant revenue for the breaches of Principles 2, 3 and 5 occurring in 2012 is £124,950,000.
- 6.12. In deciding on the percentage of the relevant revenue that forms the basis of the Step 2 figure, the Authority considers the seriousness of the breach and chooses a percentage between 0% and 20%. This range is divided into five fixed levels which represent, on a sliding scale, the seriousness of the breach; the more serious the breach, the higher the level. For penalties imposed on firms there are the following five levels:
- Level 1 – 0%
- Level 2 – 5%
- Level 3 – 10%
- Level 4 – 15%
- Level 5 – 20%
- 6.13. In assessing the seriousness level, the Authority takes into account various factors which reflect the impact and nature of the breach, and whether it was committed deliberately or recklessly. DEPP 6.5AG(11) lists factors likely to be

considered 'level 4 or 5 factors'. Of these, the Authority considers the following factors to be relevant:

- (a) Whether the breach revealed serious or systemic weaknesses in the firm's procedures or in the management systems or internal controls relating to all or part of the firm's business (DEPP 6.5A.2G(11)(b)). The nature of the breach is relevant to this factor (DEPP 6.5A. 2G(7)(a),(b),(c),(d)). The nature of the breaches is particularly serious given the significant number of breaches in this case, some of which continued for a number of years. The most serious breaches (in 2012) involved failings throughout the Firm, from traders on the SCP through SCP management, CIO London management and CIO Senior Management to the Firm's Senior Management. These breaches therefore revealed serious weaknesses in the Firm's procedures, management systems and internal controls relating to part of the Firm's business. During 2012, the Firm's Senior Management and CIO Senior Management became aware of serious warning signs indicating operational failures and control weaknesses.
- (b) The Authority has given particular regard to whether the breach had an adverse effect on markets and how serious that effect was in relation to this factor (DEPP 6.5AG(6)(f)). Market confidence was put at risk, given the announcements of losses to the market and size of the losses announced.
- (c) Whether the breach caused a significant loss or risk of loss to other market users (DEPP 6.5AG(11)(a) and DEPP 6.5A.2G(6)(a)-(b)). The trading on the SCP at February month-end risked causing a loss to other market participants.
- (d) Whether the breach was committed deliberately (DEPP 6.5A.2G(11)(f)). The mismarking (Principle 2) and market misconduct (Principle 5) were deliberate breaches. One of the purposes of part of the February month-end trading was to "*limit the damage*" to the SCP. This could have been achieved if the market price of the index moved closer to the SCP's mark. The SCP was mismarked in order to conceal mounting losses, at the instruction of SCP management. The valuation control process was

also subverted by the traders on the SCP with the intention of concealing losses at month-end.

6.14. Taking all of these factors into account, the Authority considers the seriousness of the Firm's Principle 3 breach between 6 March 2010 and 31 December 2011 to be level 4 and so the Step 2 figure for that period is 15% of £357,088,000. The figure at Step 2 in respect of this breach is therefore £53,563,000. The Authority considers the seriousness of the Firm's breaches of Principles 2, 3 and 5 in 2012 to be level 5 and so the Step 2 figure for that period is 20% of £124,950,000. The figure at Step 2 in respect of the 2012 breaches is therefore £24,990,000.

6.15. The overall figure at Step 2 is therefore £78,553,000.

Step 3: mitigating and aggravating factors

6.16. At Step 3 the Authority may increase or decrease the amount of the financial penalty arrived at after Step 2 to take into account factors which aggravate or mitigate the breach (DEPP 6.5A.3G).

6.17. The Authority considers that the following are the relevant aggravating and mitigating factors:

Aggravating factors

- (a) The previous disciplinary record and general compliance history of the firm (DEPP 6.5A.3G(2)(i)). Different areas of the Firm's business have been the subject of Final Notices published by the Authority. In May 2010, JPMorgan Securities Ltd was fined £33.32 million for breaches of the Client Money Rules. In May 2013, JPMorgan International Bank Limited was fined £3.07 million in relation to its provision of retail investment advice and portfolio investment services.
- (b) Whether the Authority's guidance or other published materials had already raised relevant concerns, and the nature and accessibility of such materials (DEPP 6.5A.3G(2)(k)). As noted above in relation to the earlier period, the Authority published a number of relevant mismarking cases, a Dear CEO letter was sent to the Firm in 2008 and there were other relevant Authority publications.

Mitigating factors

- (c) The Firm has committed a significant amount of resources to implement relevant improvements, undertaken remedial steps and taken disciplinary action against employees involved in the events leading to the regulatory breaches, including pursuing the maximum claw back of compensation.
- (d) The level of co-operation provided by the Firm during the course of the Authority's investigation.

6.18. Having taken these factors into account, the Authority considers that the Step 2 figure should be increased by 15%.

6.19. Step 3 is therefore £90,336,000.

Step 4: adjustment for deterrence

6.20. If the Authority considers the figure arrived at after Step 3 is insufficient to deter the firm who committed the breach, or others, from committing further or similar breaches, then the Authority may increase the penalty (DEPP 6.5D.4G).

6.21. The Authority considers that the Step 3 figure of £90,336,000 represents a sufficient deterrent to the Firm and others, and so has not increased the penalty at Step 4. In reaching this conclusion, the Authority has taken consideration of the Firm's concurrent settlement with the U.S. Securities and Exchange Commission.

6.22. Step 4 is therefore £90,336,000.

Step 5: settlement discount

6.23. If the Authority and the firm on whom a penalty is to be imposed agree the amount of the financial penalty and other terms, DEPP 6.7 provides that the amount of the financial penalty which might otherwise have been payable will be reduced to reflect the stage at which the Authority and the firm reached agreement (DEPP 6.5A5G). The settlement discount does not apply to the disgorgement of any benefit calculated at Step 1.

6.24. The Authority and the Firm reached agreement at Stage 1 and so a 30% discount applies to the Step 4 figure.

6.25. Step 5 is therefore £63,235,000.

Breach of Principle 11

- 6.26. The Authority has also applied the five-step framework that applies in respect of financial penalties imposed on firms to the Firm's breach of Principle 11.

Step 1: disgorgement

- 6.27. The Authority has not identified any financial benefit that the Firm derived directly from the breach.
- 6.28. Step 1 is therefore £0.

Step 2: seriousness of the breach

- 6.29. The Authority considers that the revenue generated by the SCP is not an appropriate indicator of the harm or potential harm caused by its breach.
- 6.30. The Authority has determined the Step 2 amount by taking into account those factors relevant to an assessment of the level of seriousness of the breach.
- 6.31. As noted above, DEPP 6.5AG(11) lists factors likely to be considered 'level 4 or 5 factors'. Of these, the Authority considers it relevant that the breach was committed deliberately or recklessly (DEPP 6.5AG(11)(f)). In particular:

- (a) A responsible individual appreciated there was a risk that their actions or inaction could result in a breach and failed adequately to mitigate that risk (DEPP 6.5A.2G(9)(a)).
 - (i) The Authority had clearly laid out matters relating to CIO (including the SCP) in which it had a particular interest in a letter dated 9 November 2010. The letter had been sent in the context of a more detailed supervisory relationship with the Firm. The Firm should have known that its failure to disclose numerous serious and significant events and problems regarding the SCP from January 2012 to 2 July 2012 would be in breach of Principle 11.
 - (ii) Subsequently, on 23 May 2012 the Firm's Senior Management were explicitly warned that the Authority's "appetite for further surprises was close to zero" in relation to the SCP. Nevertheless, the Firm continued to fail to mitigate the risk of a Principle 11 breach adequately in that

the Firm failed to disclose promptly evidence of potentially serious misconduct within the Firm.

- (b) On 10 April 2012 the breach was deliberate, in that a responsible individual, intended or foresaw that the likely or actual consequences of their actions would result in a breach (DEPP 6.5A.2G(8)(a)).

6.32. The Authority also considers that the following factors are relevant:

- (a) Whether the breach had an adverse effect on markets and, if so, how serious that effect was. This may include having regard to whether the orderliness of, or confidence in, the markets in question has been damaged or put at risk (DEPP 6.5A.2G(6)(f)). Failure to be open with the Authority and to disclose properly matters of which the Authority would expect notice undermines the Authority's ability to effectively supervise the markets and to meet its objectives.
- (b) The nature of the rules, requirements or provisions breached (DEPP 6.5A.2G(7)(a)). The regulatory regime necessarily relies on firms being open and co-operative. Principle 11 is therefore fundamental to the effective functioning of the regulatory system.
- (c) The frequency of the breach (DEPP 6.5A.2G(7)(b)). The Firm failed to be open and cooperative with the Authority through its repeated actions over a six month period.
- (d) Whether the firm's senior management were aware of the breach (DEPP 6.5A.2G(7)(d)). CIO London management were aware of the events and problems with the SCP, aware of the messages being passed to the Authority, and were directly involved in deliberately misleading the Authority on 10 April 2012.

6.33. Taking all of these factors into account, the Authority considers the seriousness of the Firm's Principle 11 breach to be level 4.

6.34. The figure at Step 2 is therefore £75,000,000.

Step 3: mitigating and aggravating factors

6.35. The Authority considers that the following factors aggravate the breach:

- (a) The previous disciplinary record and general compliance history of the firm (DEPP 6.5A.3G(2)(i)) (see above).
- (b) Whether FSA guidance or other published materials had already raised relevant concerns, and the nature and accessibility of such materials (DEPP 6.5A.3G(2)(k)). The Authority has published Final Notices in relation to Principle 11 breaches by other firms making very clear that complete openness and full disclosure are crucial to the regulatory regime. Despite these published materials the Firm did not comply with its Principle 11 obligations.

6.36. Having taken into account these aggravating factors, the Authority considers that the Step 2 figure should be increased by 15%.

6.37. Step 3 is therefore £86,250,000.

Step 4: adjustment for deterrence

6.38. The Authority considers that the Step 3 figure of £86,250,000 represents a sufficient deterrent to the Firm and others, and so has not increased the penalty at Step 4.

6.39. Step 4 is therefore £86,250,000.

Step 5: settlement discount

6.40. The Authority and the Firm reached agreement at Stage 1 and so a 30% discount applies to the Step 4 figure.

6.41. Step 5 is therefore £60,375,000.

Conclusion

6.42. In total therefore the Authority proposes to impose on the Firm a financial penalty of £137,610,000 comprising:

- (a) a penalty of £14,000,000 relating to the Firm's breach of Principle 3 prior to 6 March 2010;
- (b) a penalty of £63,235,000 relating to the Firm's breaches of Principles 2, 3 and 5 on or after 6 March 2010; and
- (c) a penalty of £60,375,000 relating to the Firm's breach of Principle 11.

7. PROCEDURAL MATTERS

Decision maker

- 7.1. The decision which gave rise to the obligation to give this Notice was made by the Settlement Decision Makers.
- 7.2. This Final Notice is given under, and in accordance with, section 390 of the Act.

Manner of and time for Payment

- 7.3. The financial penalty must be paid in full by the Firm to the Authority by no later than 1 October 2013, 14 days from the date of the Final Notice.

If the financial penalty is not paid

- 7.4. If all or any of the financial penalty is outstanding on 2 October 2013, the Authority may recover the outstanding amount as a debt owed by the Firm and due to the Authority.

Publicity

- 7.5. Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this notice relates. Under those provisions, the Authority must publish such information about the matter to which this notice relates as the Authority considers appropriate. The information may be published in such manner as the Authority considers appropriate. However, the Authority may not publish information if such publication would, in the opinion of the Authority, be unfair to you or prejudicial to the interests of consumers or detrimental to the stability of the UK financial system.
- 7.6. The Authority intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

Authority contacts

- 7.7. For more information concerning this matter generally, contact Helena Varney, Joanna Howard or Eleanor Searley at the Authority (on 020 7066 1000).

Jamie Symington

Financial Conduct Authority, Enforcement and Financial Crime Division

ANNEX A

RELEVANT STATUTORY PROVISIONS, REGULATORY REQUIREMENTS AND FCA GUIDANCE

1. STATUTORY PROVISIONS

- 1.1. The Authority's strategic objective, set out in section 1B(2) of the Act, is ensuring that the relevant markets function well.
- 1.2. The relevant markets include the financial markets and the markets for regulated financial services (section 1F of the Act).
- 1.3. The Authority's operational objectives are set out in section 1B(3) of the Act, and include the integrity objective.
- 1.4. The integrity objective is protecting and enhancing the integrity of the UK financial system, as set out at section 1D of the Act. The integrity of the UK financial system includes:
 - (a) its soundness, stability and resilience,
 - (b) its not being used for a purpose connected with financial crime,
 - (c) its not being affected by behaviour that amounts to market abuse,
 - (d) the orderly operation of the financial markets, and
 - (e) the transparency of the price formation process in those markets
- 1.5. Section 206 of the Act provides that if the Authority:

"considers that an authorised person has contravened a relevant requirement imposed on the person, it may impose on him a penalty, in respect of the contravention, of such amount as it considers appropriate".
- 1.6. The Firm is an authorised person for the purposes of section 206 of the Act.

2. REGULATORY PROVISIONS

- 2.1. In exercising its power to issue a financial penalty, the Authority must have regard to the relevant provisions in the Handbook of rules and guidance (the "Handbook").
- 2.2. In deciding on the action proposed, the Authority has also had regard to guidance published in the Authority Handbook and set out in the Regulatory Guides, in particular the Decision Procedure and Penalties Manual ("DEPP").

3. PRINCIPLES FOR BUSINESSES (PRIN)

- 3.1. The Principles are a general statement of the fundamental obligations of firms under the regulatory system and are set out in the Handbook. They derive their authority from the rule-making powers as set out in the Act and reflect the Authority's regulatory objectives. The relevant Principles are as follows:
- 3.2. Principle 2 provides: "*A firm must conduct its business with due skill, care and diligence*".
- 3.3. Principle 3 provides: "*A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems*".
- 3.4. Principle 5 provides: "*A firm must observe proper standards of market conduct*".
- 3.5. Principle 11 provides: "*A firm must deal with its regulators in an open and cooperative way, and must disclose to the appropriate regulator appropriately anything relating to the firm of which that regulator would reasonably expect notice*".

4. DECISION, PROCEDURE AND PENALTIES MANUAL (DEPP)

- 4.1. Guidance on the imposition and amount of penalties is set out in Chapter 6 of DEPP. Changes to DEPP were introduced on 6 March 2010. Given that the misconduct occurred both before and after that date, the Authority has had regard to the provisions of DEPP in force before and after that date.
- 4.2. The Authority has also had regard to the provisions of the Enforcement manual (ENF) in force prior to 28 August 2007, in relation to misconduct which occurred prior to that date.